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# The Indenture Trustee: Does It Really Protect Bondholders?

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# THE INDENTURE TRUSTEE: DOES IT REALLY PROTECT BONDHOLDERS?

EFRAT LEV, ADV.\*

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## I. INTRODUCTION

The Trust Indenture Act of 1939 (hereinafter "TIA" or "the Act")<sup>1</sup> is one of the most overlooked enactments in the area of securities law. Jurisprudence involving the Act is scarce, and even before the Act was passed the corporate trust indenture did not get much attention from either courts or commentators. In 1928 Louis Posner wrote, "[I]t is noteworthy that...so little [was] written upon in the 50 years during which this field of law has been developing. Indeed, the comparatively few cases, which deal with the subject, leave many of its problems altogether untouched."<sup>2</sup> Not only courts but also legal scholars have paid relatively little attention to the TIA. Furthermore, those who are involved in the business of securities and bonds issuance are commonly unaware of its existence. Even when aware, bondholders seldom appreciate its significance. This article does not proclaim these investors wrong because the current structure of the TIA, and the character of its main creation – the indenture trustee – support such an attitude. Designed to protect investors, the TIA is seldom capable of effectively doing so, and therefore it is thought of as a technical, burdensome and even archaic piece of legislation. But it is questionable whether investors and society as a whole can really afford to ignore a mechanism that could protect investments that lubricate the economy.

One of the most popular ways of borrowing money from the public is to issue debt securities, commonly referred to as bonds.<sup>3</sup> In fact, bond issuance by corporations is probably one of the most significant factors in the development and success of the industrialized world and has contributed to the economy through the advancement of capital to corporations.<sup>4</sup> And in fact, the bond market is far larger than the stock market.<sup>5</sup> From 1991 to 1993,

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<sup>1</sup> The TIA is found at Title 15 of the United States Code.

<sup>2</sup> Louis S. Posner, *Liability of the Trustee Under the Corporate Indenture*, 42 HARV. L. REV. 198 (1928).

<sup>3</sup> A few remarks should be made with regard to the terminology used in this article. "Indenture securities" in the United States are popularly classified as "bonds," which are long-term and secured obligations, and "debentures," which are long-term unsecured obligations. Short-term obligations, either secured or unsecured, are commonly referred to as "notes." For convenience reasons, the term "bonds" will be used here for all long-term obligations, unless otherwise mentioned, and the holders of those obligations will be identified as bondholders. Also note that the terms "obligor" and "issuer" are used interchangeably and refer to the corporation which has issued the bonds and therefore carry the obligation to pay back the debt. The indenture trustee or corporate trustee will be simply regarded as "the trustee."

<sup>4</sup> See Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, NW. U. L. REV. 565, 566 (1995).

<sup>5</sup> See *id.*

companies raised three times more money from bond issues than from stock issues.<sup>6</sup>

Nevertheless, the success in raising capital by issuing bonds did not come without a price. Indeed, throughout the years, bondholders have experienced some dramatic losses.<sup>7</sup> In the 1970s, such losses were attributed to the recapitalization methods employed by many corporations.<sup>8</sup> The hostile takeover wave of the 1980s was blamed for the next surge of bond defaults.<sup>9</sup> During the 1990s, mergers and acquisitions were pointed to as a factor in increasing the financial risk of corporations.<sup>10</sup> Consequently, one must ask whether the legal network that governs bond issuance adequately protects the bondholders.

Apart from the securities laws, the most important legislation that controls bonds is the TIA. The Act relies on a contract — the trust indenture — to define the rights and responsibilities of the corporate obligor, the bondholders, and the trustee. The trustee is in the center of the mechanism that was designed to protect bondholders. The trustee is also at the center of this study's discussion.

The second section of this study provides a historical background that describes the earliest usage of the indenture and the corporate trustee. Thereafter, the developments leading to the enactment of the TIA are examined. These developments highly contributed to the drafting process of the TIA and they also illustrate the necessity of a protective mechanism for bondholders. In the third section, the TIA is generally described, with special attention to the important amendments of 1990.

The fourth section is dedicated to the trust indenture. Unfortunately, bondholders are usually unaware of the existence of the indenture, let alone its specific provisions.

The fifth section deals with the trustee's role in the pre-default situation. The section strongly suggests that the customary distinction between the trustee's duties pre-default versus post-default is undesirable and does not serve the bondholders' interests. This assertion is further argued in the sixth section, which deals with conflicts of interest and illustrates how the problematic conflict between the trustee and the bondholders might jeopardize

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<sup>6</sup> See *id.*

<sup>7</sup> See *id.* at 567.

<sup>8</sup> See Ronald W. Masulis, *The Effects of Capital Structure Change on Security Prices*, 8 J. FIS. ECON. 139, 171 (1980).

<sup>9</sup> See Kahan, *supra* note 4, at 567.

<sup>10</sup> See Marcel Kahan & Micheal Klausner, *Anti-takeover Provisions in Bonds: Bondholders Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 933 n.2 (1993).

the bondholders' chances of getting their money back, both before and after default.

In the seventh section, the post-default role of the trustee is examined. The eighth section reviews the possible causes of action available to bondholders who have suffered losses due to the trustee's conduct. In the ninth and final section, a recent article, written by Yakov Amihud, Kenneth Garbade and Marcel Kahan, which suggests a new governance structure for corporate bonds and introduces a new concept of "supertrustee," is examined and criticized.

## II. HISTORICAL BACKGROUND

First known as a "corporate mortgage," a trust indenture has been used as the basis for selling corporate obligations to the public for almost 170 years.<sup>11</sup> It later became known as a "trust indenture."<sup>12</sup> The earliest example of a trust indenture in the United States dates back to 1830 and was known as a "Dutch loan."<sup>13</sup> In this transaction, the Morris Canal & Banking Company conveyed its property in trust to an Amsterdam merchant in order to secure a loan of \$750,000, which was made by several individuals.<sup>14</sup> The trustee was given the right to take possession of the mortgaged premises in case of default and to take and receive the rents and profits.<sup>15</sup> The legal instrument that was used was a "deed of trust," which served as a common-law mortgage.<sup>16</sup> With a deed of trust, the legal title of the property is placed in one or more trustees, to secure the repayment of the debt.<sup>17</sup> By 1860, the use of a trustee as the bondholders' representative became common.<sup>18</sup> In 1873, when dealing with a mortgage that made no provision for a trustee, the United States Supreme Court noted that it was "a departure from ordinary practice."<sup>19</sup> Ever since, the American industry has strongly relied on obligation issuance under trust indentures to finance its extraordinary growth throughout the 20th Century.

In the 19th Century, the construction of railroads and other transportation means required large investments.<sup>20</sup> However, the corporations involved in

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<sup>11</sup> See Cecil M. Draper, *A Historical Introduction to the Corporate Mortgage*, 2 ROCKY MNT. L. REV. 71, 76 (1930).

<sup>12</sup> See *id.* at 86.

<sup>13</sup> See Talcott M. Banks, *Indenture Securities and the Barkley Bill*, 48 YALE L.J. 533 (1939).

<sup>14</sup> See Draper, *supra* note 11, at 76.

<sup>15</sup> See *id.* at 77.

<sup>16</sup> See *id.*

<sup>17</sup> See generally *Larchmont Homes, Inc. v. Annandale Water Co.*, 110 S.E.2d 249 (Va. 1959).

<sup>18</sup> See George E. Palmer, *Trusteeship Under the Trust Indenture*, COLUM. L. REV. 193, 195 (1941).

<sup>19</sup> *Nashville & Decatur R.R. Co. v. Orr*, 85 U.S. 471 (1873).

<sup>20</sup> See Banks, *supra* note 13, at 538.

these industries could no longer rely on large financing institutions for funding, for that source of capital was limited.<sup>21</sup> Rather, they needed access to the public's capital.<sup>22</sup> To attract the conservative investing public, the investment had to be secured.<sup>23</sup> The customary security of those days was a mortgage on the debtor's property. However, given the large number of investors, who were often geographically scattered, a simple mortgage was impractical.<sup>24</sup> These numerous lenders were therefore in a particularly vulnerable position because their incentive to monitor the issuer and make decisions regarding an enforcement action was largely reduced.<sup>25</sup> Under these circumstances, a bondholder found it very hard, if not impossible, to detect any breaches in the loan agreement.<sup>26</sup>

A plan was therefore introduced in which the mortgage was granted to a single individual, who held it in trust for the investors.<sup>27</sup> This arrangement fulfilled two functions. First, before default, the trustee was merely a repository of the noteholders' interests in the security, which was held in escrow or as a stakeholder.<sup>28</sup> Second, after default, if foreclosure was necessary, the trustee was the investors' agent to effectuate the foreclosure.<sup>29</sup> The position required only a reliable person, and little regard was paid to conflicts of interest.<sup>30</sup> Thus, there were examples of the same individual acting as trustee under two or more mortgages executed by the same company.<sup>31</sup>

By the end of the 19th Century, the trustee's powers and duties had increased, largely to the benefit of the investors.<sup>32</sup> Consequently, it was customary to appoint two or three individuals to hold the position of the trustee.<sup>33</sup> At a later stage, the individual trustee or trustees were frequently replaced with a corporation and the term "corporate trustee" was established.<sup>34</sup>

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<sup>21</sup> See *id.*

<sup>22</sup> See *id.*

<sup>23</sup> See *id.*

<sup>24</sup> See *id.*

<sup>25</sup> See *id.*

<sup>26</sup> See *id.*

<sup>27</sup> See Draper, *supra* note 11, at 74.

<sup>28</sup> See Banks, *supra* note 13, at 535.

<sup>29</sup> See *id.*

<sup>30</sup> See *id.*

<sup>31</sup> See *id.*

<sup>32</sup> See *id.* at 536.

<sup>33</sup> See Draper, *supra* note 11, at 81-82.

<sup>34</sup> See *id.* at 83.

The earliest examples of corporate trustees were designed as certificates of deposit or escrow agreements rather than as trustee deeds.<sup>35</sup> These legal instruments were designed to secure some assets in favor of creditors and allowed execution of the debt by a third party if the triggering events occurred.<sup>36</sup> Although different from a modern trusteeship, such certificates of deposit and escrows were the direct ancestors of the corporate indenture trustee as we know it today.<sup>37</sup>

In general, corporate trustees became common after 1880.<sup>38</sup> The initial intent was to avoid the problems related to a trustee's death, but the aim eventually became to accommodate the trustee's growing burden.<sup>39</sup> At that time, no attention was paid to the question of conflicts of interest.<sup>40</sup>

### III. THE TRUST INDENTURE ACT OF 1939

The 1929 financial crash and the Great Depression of the 1930s were obviously the main incentives for the legislative decision to regulate the securities market.<sup>41</sup> Thanks to numerous defaults, financial collapses, and personal tragedies of that era, the financial community and many trust institutions suffered a sudden decline in public respect, faith and goodwill.<sup>42</sup> One commentator, writing in the midst of the Depression, thought that the conduct of indenture trustees had contributed to those losses.<sup>43</sup> He asserted that the fiduciary duties of indenture trustees were poorly implemented and

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<sup>35</sup> See *id.* at 84. The reason for using deposit and escrow structures to execute those transactions was due to the uncertainty concerning the power of the corporation to act in a trustee's capacity. This doubt soon evaporated, however, and it became customary to use corporate trustees, first under a regular trust deed and later under an indenture.

<sup>36</sup> See *id.* at 79.

<sup>37</sup> See *id.* at 85. In 1835, the Farmer's Loan & Trust Co., considered the earliest corporate trustee, held funds in trust for the Long Island Railroad Co. under what was "clearly a certificate of deposit." See also Banks, *supra* note 13, at 535. In 1839, the Girard Life Insurance, Annuity & Trust Co. was a trustee of obligations issued by Beaver Meadow Railroad & Coal Co. under what can be viewed as an escrow agreement.

<sup>38</sup> See Banks, *supra* note 13, at 538.

<sup>39</sup> See *id.*

<sup>40</sup> See Draper, *supra* note 11, at 79 (corporations were serving as trustees under separate mortgages of the same companies and officers of the mortgagor were appointed as trustees); see also Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982) (the company's road was mortgaged to the president of the company and his successors as trustees of the bondholders).

<sup>41</sup> See, e.g., Frederica R. Obrzut, *The Trust Indenture Act of 1939: The Corporate Trustee as Creditor*, 24 UCLAL. REV. 131, 135 (1976); see also Henry F. Johnson, *The 'Forgotten' Securities Statute: Problems in the Trust Indenture Act*, 13 U. TOL. L. REV. 92, 93-6 (1981).

<sup>42</sup> See, e.g., Obrzut, *supra* note 41.

<sup>43</sup> See Stone, *The Public Influence of the Bar*, 48 HARV. L. REV. 1, 8 (1934).

implied that the relief of such trustees from their obligations by "clever legal devices" would be regretted.<sup>44</sup> In the specific market of obligation issues, the uncertainty that surrounded the trustees' conduct and duties contributed to the atmosphere leading to the loss of confidence and eventually to chaos.<sup>45</sup> The Trust Indenture Act can be seen as part of the general effort to re-establish the public confidence in the money market and the securities market.<sup>46</sup>

Just prior to the TIA, investor losses spawned a large number of lawsuits against trustees alleging breach of fiduciary duty.<sup>47</sup> Unfortunately, this litigation ended up adding even more confusion to the subject as no consistent jurisprudence developed from the litigation.<sup>48</sup>

The loss of confidence in the American financial structure dictated a reaction from Congress. The first legislation was the Securities Act of 1933 (hereinafter "the Act"),<sup>49</sup> which mainly required an issuer of securities to disclose information prior to issuance and imposed penalties for misrepresentation and misleading investors. Following that, the Securities Exchange Act of 1934 was enacted and established the Securities and Exchange Commission (hereinafter "the SEC").<sup>50</sup>

The SEC appointed a committee, which submitted its report to Congress in June 1936.<sup>51</sup> The SEC conducted an investigation and stated its observations and conclusions in a report, which highly criticized the existing modus operandi of public financing debt.<sup>52</sup> The dramatically written report

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<sup>44</sup> *Id.*

<sup>45</sup> See Obrzut, *supra* note 41, at 134-35.

<sup>46</sup> See Johnson, *supra* note 41, at 93.

<sup>47</sup> See Banks, *supra* note 13.

<sup>48</sup> See *Green v. Title Guarantee & Trust Co.*, 227 N.Y.S.2d 252, 256 (N.Y. App. Div. 1928) (the court ruled that provisions in the indenture, aimed at providing the trustee with immunity, did not lessen the trustee's duties in relation to the mortgage); see also Posner, *supra* note 2, at 201 (regarding the *Green* decision as "a departure from precedent," and troubled by the court's emphasis on the trustee's status as a fiduciary instead of the trustee's status as being a creation of the contract and bound only by the contract's provisions); *Hazzard v. Chase Nat'l Bank of the City of New York*, 287 N.Y.S. 541 (N.Y. Sup. Ct. 1936), (The indenture provided that the obligor could take back the pledged stock if he substituted it with other stock that met certain minimum requirements. The obligor took advantage of this clause with the permission of the trustee. However, the company that issued the substitute security went bankrupt. This resulted in a total loss of value to the bondholders who claimed that the trustee was negligent when it approved the exchange of security. In court, the trustee relied upon an exculpatory clause in the indenture, claiming it fully complied with the terms of the indenture. The court concluded that it could not impose liability on the trustee in accordance with the view that the indenture is the only source of the trustee's obligations.); Banks, *supra* note 13, at 545 (suggesting that the case did not represent good law and that courts in other jurisdictions could rule otherwise or that the case was severely limited to its facts).

<sup>49</sup> Securities Act of 1933, 15 U.S.C. §§ 77a et seq. (1997).

<sup>50</sup> Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. (1997).

<sup>51</sup> See Johnson, *supra* note 41, at 96.

<sup>52</sup> See Obrzut, *supra* note 41, at 132-33.



ascertained the shortcomings of trustees by describing litigated cases noting that "the interests of prospective purchasers of securities are adequately represented by no one."<sup>53</sup> In some of the described cases, there were indications of active fraud by the trustee.<sup>54</sup> Other cases, like *Hazzard v. Chase National Bank*, reflected the broad exculpatory clauses in indentures that allowed negligent trustees to escape liability.<sup>55</sup> The decisive conclusion of the report was that investors must have "an active guardian of their interests throughout the entire life of the security."<sup>56</sup> This "active guardian" was further defined as a guardian stripped from all conflicting interests and carrying full fiduciary duties.<sup>57</sup>

Following the SEC's report, the Barkley Bill was introduced to the Senate in 1937. The purpose of the bill was three-fold:

1. To assure there is full disclosure throughout the life of the securities, and not just at issuance.
2. To provide a mechanism that will allow bondholders to convene and act for the sake of their interests.
3. To assure that the indenture trustee is disinterested and conforms to high standards of conduct.<sup>58</sup>

The modified bill was enacted as the Trust Indenture Act of 1939 and became effective as of February 3, 1940.<sup>59</sup> The TIA was passed three years after the SEC's report was issued and apparently had "less harsh solutions" than the ones presented by the report.<sup>60</sup> This outcome was attributed to the conception that the report was extremely prejudiced against the business sector.<sup>61</sup> Some believe that the early years of the SEC's operation were characterized by an overly enthusiastic approach directed at thoroughly regulating the securities market for the supposed benefit of the investors.<sup>62</sup>

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<sup>53</sup> SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES PART VI-TRUSTEES UNDER INDENTURES 22 (1936) [hereinafter "SEC Report"].

<sup>54</sup> See Banks, *supra* note 13, at 537.

<sup>55</sup> *Hazzard v. Chase Nat'l Bank*, 287 N.Y.S.2d 541 (N.Y. Sup. Ct. 1936).

<sup>56</sup> SEC Report, *supra* note 53, at 25.

<sup>57</sup> See Banks, *supra* note 13, at 537.

<sup>58</sup> See H.R. REP. NO. 76-1016 (1939); see also Robert G. Miller, *The Trust Indenture Act of 1939*, 25 CORNELL L. REV. 105, 109 (1939).

<sup>59</sup> Trust Indenture Act of 1939, 15 U.S.C. § 77s (1997).

<sup>60</sup> Obrzut, *supra* note 41, at 133.

<sup>61</sup> See *id.* at 133 n.7.

<sup>62</sup> See *id.*

According to Robert Landau, the enacted TIA differed from the initial SEC report and from the Barkley Bill in the role of the SEC after the issuance of the bonds.<sup>63</sup> Both the report and the bill recommended that the SEC should have continuous supervisory administration, whereas the TIA requires that the indenture would adhere to the SEC's "qualification" only upon registration of the securities.<sup>64</sup> No continuing supervisory powers were granted to the SEC. This limited authority of the SEC is even more surprising in light of the broad enforcement powers given to the SEC under Section 20 of the Securities Act of 1933<sup>65</sup> and under Section 21 of the Securities Act of 1934.<sup>66</sup>

In any case, the investing public was presumed to be fully protected by the trustee under the TIA.<sup>67</sup> One commentator noted that it was hoped that the TIA would be the investor's silent representative during the drafting of the indenture.<sup>68</sup> The trustee was then expected to be a louder representative with the power to act in the best interests of the scattered bondholders.

The TIA applies to notes, bonds, debentures, and other certificates of indebtedness, whether or not secured.<sup>69</sup> It also applies to certificates of interest or participation of such a note including a temporary one.<sup>70</sup> The TIA demands that any issuer of public bonds qualifies by subjecting itself to the TIA's requirements, with certain exemptions. Examples of these exemptions are issues made by a foreign government,<sup>71</sup> issues exempted by the Securities Act of 1933,<sup>72</sup> and issues of less than \$10,000,000.<sup>73</sup> The latter exemption is designed to reflect the size and capital needs of American businesses while at the same time enabling small corporations to issue debt without the costs involved in the selection and administration of an indenture trustee.<sup>74</sup>

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<sup>63</sup> See ROBERT I. LANDAU, *CORPORATE TRUST ADMINISTRATION AND MANAGEMENT* 37 (4th ed. 1992).

<sup>64</sup> 15 U.S.C. § 77eee(b).

<sup>65</sup> *Id.* § 77s.

<sup>66</sup> *Id.* § 78u.

<sup>67</sup> See Howard M. Friedman, *Updating the Trust Indenture Act*, 7 J. L. REFORM 329, 330 (1974).

<sup>68</sup> See Obrzut, *supra* note 41, at 135.

<sup>69</sup> See 15 U.S.C. § 77ddd(a)(1).

<sup>70</sup> See *id.*

<sup>71</sup> See *id.*

<sup>72</sup> Securities exempt under the Securities Act of 1933, and therefore exempted under the TIA include government securities, bank securities, insurance policies, commercial paper, securities of completely intrastate issue and securities of charitable, non-profit organizations. See James E. Spiotto, *Overview of SEC Regulation and Investigation Relevant to Indenture Trustees and Defaulted Bonds*, 288 PLI/REAL 267, exhibit A (1987). Securities sold in "private placement" transactions are also exempted. See 15 U.S.C. § 77ddd(a)(4).

<sup>73</sup> See *id.* § 77ddd(a)(9).

<sup>74</sup> See Johnson, *supra* note 41, at 98. The threshold amount was initially set at \$250,000, and was revised in 1976 to \$10,000,000. Indenture trustees' fees for an unsecured bond generally range from \$5,000

In general, the legislation establishes certain minimum requirements directed at the trustee as well as the obligor. It imposes specified responsibilities, accountability and qualifications upon the trustee, along with a compulsory inclusion of certain provisions in the indenture. Of course, the TIA does not eliminate the occurrence of defaults, as no reasonable legislation could, but does give the contractors of the indenture a promising framework for the transaction. In comparison to the situation prior its enactment, the TIA provides better protection for investors. The most visible evidence of the success of the TIA in the business world is its adoption by indentures that are not governed by the Act (as in the case of direct placements).

#### A. Trustee-related Issues Under the Trust Indenture Act

The eligibility requirements for trustees are set forth in Section 310 of the TIA.<sup>75</sup> These requirements apply to both the original trustee and to a successor trustee should there be one.<sup>76</sup> Federal, state or territorial law must authorize the trustee to exercise corporate trust powers.<sup>77</sup> The TIA demands that at least one of the trustees is organized to do business under the laws of the United States.<sup>78</sup> The trustee must also continuously have a combined capital and surplus of no less than \$150,000.<sup>79</sup> This requirement makes it unlikely that the trustee would be an individual. Given the broad and burdensome tasks of the trustee, this was one of the goals of the TIA.<sup>80</sup> However, these minimum requirements allow almost any banking institution normally exercising trust powers to act as an indenture trustee.<sup>81</sup> Many indentures, however, impose a minimum combined capital and surplus of \$5 million, and some indentures require the trustee to have at least \$25 million of combined capital and surplus at all times.<sup>82</sup>

Conflicts of interest, discussed later,<sup>83</sup> are one of the central difficulties in this area. One of the main objects of the writers of the SEC's report and of the TIA was to disqualify any institution with a conflict of interest from being a

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to \$10,000 per year. See Yakov Amihud et al., *A New Government Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 479 n.111 (1999).

<sup>75</sup> See 15 U.S.C. § 77jjj.

<sup>76</sup> See *id.* § 77jjj(a)(1).

<sup>77</sup> See *id.*

<sup>78</sup> See *id.*

<sup>79</sup> See *id.* § 77jjj(a)(2).

<sup>80</sup> See LANDAU, *supra* note 63.

<sup>81</sup> See *id.*

<sup>82</sup> See *id.*

<sup>83</sup> See discussion *infra* Part VI.

trustee for a specific issuer.<sup>84</sup> Indeed, this disqualification was one of the innovations introduced by the TIA. The Act specifically addresses trusteeship under more than one indenture, ownership of securities by the trustee, and other affiliations between the trustee and the obligor.<sup>85</sup> Yet, while setting some "rules of thumb," the Act did not eliminate all potential conflicts, and the issue remained under debate, at least until it was amended in 1990.<sup>86</sup>

"Exculpatory provisions," which were an attempt to exempt the trustee from liability for any act or failure to act, short of willful misconduct or gross negligence, were also addressed by the TIA.<sup>87</sup> These provisions were subject to criticism and controversy before the TIA came into effect, because it had been customary to include them in indentures.<sup>88</sup> Section 315(d) of the TIA prohibits the inclusion of such broad immunity provisions in the indenture.<sup>89</sup> It determines that the trustee would be responsible for its negligent action or failure to act and its willful misconduct.<sup>90</sup> Yet, the trustee is still immunized against any error in judgment made in good faith by a responsible officer where the trustee was not negligent in ascertaining the pertinent facts.<sup>91</sup>

Section 315 of the TIA describes the trustee's duties and responsibilities.<sup>92</sup> According to Section 315(a), prior to default, the trustee may be liable only for duties the indenture specifically sets out.<sup>93</sup> Therefore, unless otherwise instructed, the trustee bears no implied duties, but only explicit ones. The same applies in post-default situations, with the addition of setting "the prudent person" standard as to the degree of skill and care required from the trustee at this stage.<sup>94</sup> These provisions made the indenture itself a highly important document as to the trustee's duties and emphasized the contractual nature of the indenture.

### B. *The Trust Indenture Reform Act of 1990*

The first comprehensive revision of the TIA became effective as of November 15, 1990. The Trust Indenture Reform Act of 1990 (hereinafter

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<sup>84</sup> See Friedman, *supra* note 67, at 329 n.4.

<sup>85</sup> See 15 U.S.C. § 77jjj(b).

<sup>86</sup> See, e.g., Friedman, *supra* note 67, at 330.

<sup>87</sup> See 15 U.S.C. § 77ooo(d).

<sup>88</sup> See generally Banks, *supra* note 13.

<sup>89</sup> See 15 U.S.C. § 77ooo(d).

<sup>90</sup> See *id.*

<sup>91</sup> See *id.*

<sup>92</sup> See *id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

"TIRA") was designed to modernize the fifty-year-old TIA.<sup>95</sup> The TIRA provisions apply to all outstanding indentures.<sup>96</sup> In cases of conflict between the TIRA and an existing indenture, which are not related to optional provisions, the TIRA will prevail.<sup>97</sup> Thus, Congress applied the TIRA retroactively.<sup>98</sup>

Regarding eligibility of a trustee, the TIRA enables a foreign bank to become a trustee under specific conditions.<sup>99</sup> It also increases the efficiency of the issuance process by allowing the obligor to register the securities and apply for the trustee's approval by the SEC simultaneously.<sup>100</sup> However, the minimum requirement of \$150,000 of combined capital and surplus and other substantive requirements were not altered.<sup>101</sup> Although not directly connected to the bondholders' investment, the fact that these qualifying factors were not updated on this occasion casts doubt on the modernizing effect of the TIRA. The fact that the market itself tends to adjust to reality and demands higher standards from the trustee, surely cannot justify the low threshold the TIA sets.

Regarding conflicts of interest, the TIRA prohibits the trustee from being or becoming a creditor of the obligor and its affiliates.<sup>102</sup> This modification was probably the result of strong criticism by many commentators and was the most promoted proposition recommended over the years.<sup>103</sup> On the other hand, the TIRA allows the postponement of the trustee's resignation for any conflict of interest until there is a default under the indenture.<sup>104</sup> There is an exception according to which the obligor and its affiliates cannot serve as trustees for its own securities at all times.<sup>105</sup> Still, the suspension of resignation may point out that the TIA recognizes and emphasizes the administrative role of the trustee prior to default.<sup>106</sup> In any case, there is little

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<sup>95</sup> See Trust Indenture Reform Act of 1990, Pub. L. No. 101-550, 104 Stat. 2721 (1990).

<sup>96</sup> See *id.*

<sup>97</sup> See *id.*

<sup>98</sup> See 15 U.S.C. §77mm(c).

<sup>99</sup> See *id.*

<sup>100</sup> See Trust Indenture Reform Act, 104 Stat. 2721.

<sup>101</sup> See *id.*

<sup>102</sup> See Trust Indenture Act of 1939 § 310(b)(i), 15 U.S.C. § 77jjj(b)(i) (1997).

<sup>103</sup> See, e.g., John P. Campbell and Robert Zack, *Put a Bullet in the Poor Beast, His Legs Are Broken and His Use Is Past. Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: A Proposal To End It in the Public Interest*, BUS. LAW. 1705, 1710 (1977); see also Johnson, *supra* note 41, at 101.

<sup>104</sup> See 15 U.S.C. § 77jjj(b)(i).

<sup>105</sup> *Id.* § 77jjj(b)(iii).

<sup>106</sup> See LANDAU, *supra* note 63, at 58.

doubt that even after the TIRA, the TIA does not provide a thorough solution to the problem of conflicts of interest.

The TIRA also eliminated the need to set out all the provisions of TIA Sections 310 through 317 in the indenture.<sup>107</sup> These provisions include, among other things, directions regarding the eligibility and duties of the trustee, and reports furnished by the trustee and the obligor.<sup>108</sup> The TIRA now mandates such provisions as a matter of federal law.<sup>109</sup> It incorporates them in the indenture and they are presumed to control the relationship unless they are expressly excluded.<sup>110</sup> Thus, the trustee's annual report is now sent to bondholders only at the occurrence of enumerated changes in circumstances and not automatically each year.<sup>111</sup> In contrast, the obligor is required to provide the trustee with an annual no-default certificate signed by the principal executive officer, the principal financial officer, or the principal accounting officer.<sup>112</sup>

Two more significant modifications were included in the TIRA. One is the determination that a trustee's successor will become effective only upon fulfilling eligibility requirements (so that a no-trustee situation is never possible).<sup>113</sup> The other is the granting to the SEC of a wide authority to exempt any person or security from the provisions of the Act.<sup>114</sup>

The TIRA amendments were the result of a five-year ad hoc effort of seven major corporate-trustee banks.<sup>115</sup> Although its purpose was to formally furnish the market with a modernized TIA, the amendments seemed to have benefited the trustee and obligor more than the investors. Admittedly, the TIRA attempted to resolve the problem of the conflict of interest when the trustee is also a creditor of the obligor. Nevertheless, the TIRA did not make any dramatic modifications in the role of the trustee and its defined duties and responsibilities (especially prior to default) and it did not provide adequate solutions to the various problems raised and dealt with by courts and scholars over the years.

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<sup>107</sup> See 15 U.S.C. § 77mm(c).

<sup>108</sup> See *id.*

<sup>109</sup> See *id.*

<sup>110</sup> See *id.*

<sup>111</sup> See *id.* § 77mmm(a).

<sup>112</sup> See *id.* § 77nnn(c).

<sup>113</sup> See *id.* § 77jjj(a)(1).

<sup>114</sup> See *id.* § 77ddd(d).

<sup>115</sup> See LANDAU, *supra* note 63, at 39.

#### IV. THE TRUST INDENTURE

##### A. *The Nature of the Trust Indenture*

Throughout the years the trust indenture has been used, its legal nature has never been clearly defined. Is it a trust subject to the trust law or is it a mortgage? Or is it merely a contractual instrument? Courts have struggled with these questions ever since the trust indenture came into existence yet no uniformity as to the trust relationship has evolved. The answer to these questions is not purely theoretical. It comes down to the nature of the relationships between the parties, including the duties they bear and the rights to which they are entitled. The result, therefore, of any given dispute between the parties is largely determined by how the indenture is defined in court.

In *Ashurst v. Montour Iron Co.*, the Pennsylvania Supreme Court defined the relationship under a trust indenture as "tripartite in substance and effect."<sup>116</sup> The two contracting parties, the obligor and the trustee, were regarded as having a mortgage-based relationship, in which one is a mortgagee and the other a mortgagor.<sup>117</sup> The court recognized the creditors as a party to the indenture.<sup>118</sup> It described them as "unascertained indeed, when the instrument is made, but well-known as a party when the remedies come to be discussed."<sup>119</sup> The court concluded that between the creditors and the trustee, the indenture is "nothing but a trust."<sup>120</sup> This two-headed analysis, made in 1860, was still regarded as the best suggestion for legal interpretation of the nature of this document, at least until the enactment of the TIA, if not long after.

Before the TIA was enacted, courts struggled with the issue of how to deal with an indenture trustee. On the one hand, the trustee was obligated to a class of beneficiaries much like a traditional trustee. On the other hand, its duties were limited by the terms of the indenture with many exculpatory clauses.

Most pre-TIA courts found the indenture trustee to be, both in theory and in practice, considerably less than a genuine trustee.<sup>121</sup> However, in *Hazzard v. Chase National Bank*, the court held that the trustee is essentially a

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<sup>116</sup> *Ashurst v. Montour Iron Co.*, 35 Pa. 30, 43 (1860).

<sup>117</sup> *See id.*

<sup>118</sup> *See id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> *See* Martin D. Sklar, *The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?*, 106 BANKING L.J. 42, 50 (1989).

stakeholder and its rights and duties are determined exclusively by the indenture.<sup>122</sup> Other courts, like the influential Court of Appeals for the Second Circuit, found in the case of *Frishmuth v. Farmers' Loan & Trust Co.*, that a trustee bears full fiduciary obligations arising solely from the relations between the parties regardless of the terms of the indenture.<sup>123</sup> In *Frishmuth*, the trustee had failed to examine the value of the property that served as security for the debt.<sup>124</sup> The property was eventually found to be worthless and the court regarded as irrelevant the limited duty of the trustee explicitly described in the indenture and the broad exculpatory clause.<sup>125</sup> It was held that the trustee's duties "are not those only which are defined by the terms of the [indenture]."<sup>126</sup>

Some scholars asserted the relationship between the trustee and its beneficiaries as personal or family trust relations.<sup>127</sup> Others considered the relationship as *sui generis* in character "combining elements of several other legal relationships but being identical with none."<sup>128</sup> Of course, courts were no less divergent than the scholars. On different occasions, courts held that the relationship between the trustee and the bondholders was fiduciary,<sup>129</sup> or subject to agency theory,<sup>130</sup> or contractual in nature.<sup>131</sup> Currently, most courts agree that the indenture does not create a trust relationship as customarily considered in the private field, but many of them still regard the trustee as subject to full fiduciary responsibilities.

The Second Circuit in *Dabney v. Chase*, for example, stated that the trustee must give his beneficiaries "undivided loyalty."<sup>132</sup> In *United States Trust Co. of New York v. First National Bank*, a successor trustee claimed that the original trustee favored its own interest as creditor of the issuer over the bondholders' interest.<sup>133</sup> The original trustee contended that its duties were purely contractual and that it was not really a trustee in the traditional

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<sup>122</sup> *Hazzard v. Chase Nat'l Bank*, 287 N.Y.S.2d 541 (N.Y. Sup. Ct. 1936).

<sup>123</sup> *Frishmuth v. Farmers' Loan & Trust Co.*, 95 F. 5, 8 (S.D.N.Y. 1899).

<sup>124</sup> *See id.* at 5.

<sup>125</sup> *See id.* at 8.

<sup>126</sup> *Id.*

<sup>127</sup> *See* LANDAU, *supra* note 63, at 22.

<sup>128</sup> *Id.*

<sup>129</sup> *See, e.g., York v. Guaranty Trust Co.*, 143 F.2d 503, 513 (2d Cir. 1944), *reversed on other grounds*, 326 U.S. 99 (1945).

<sup>130</sup> *See, e.g., First Trust Co. of Lincoln v. Carlsen*, 261 N.W. 333 (Neb. 1935).

<sup>131</sup> *See e.g., Hazzard*, 287 N.Y.S.2d at 564.

<sup>132</sup> *Dabney v. Chase*, 196 F.2d 668, 671 (2d Cir. 1952).

<sup>133</sup> *United States Trust Co. of New York v. First Nat'l Bank*, 394 N.Y.S.2d 653, 660-61 (N.Y. App. Div. 1977). *See id.* at 660-61.



meaning.<sup>134</sup> The court, rejecting the contentions of the original trustee, held the trustee liable for breach of its fiduciary obligation of loyalty.<sup>135</sup> The court added that regardless of the very narrow duties defined in the indenture, the TIA was not intended to take away from bondholders any protection they had before, but only to add protections.<sup>136</sup> In *Broad v. Rockwell*, the First Circuit Court of Appeals published a less clear decision, but it still imposed fiduciary duties on trustees.<sup>137</sup> The *Broad* court held that the TIA already includes a fiduciary obligation and the trustee's duties should be read from the TIA, the indenture and the state law.<sup>138</sup>

To shuffle the cards again, the Second Circuit Court of Appeals, in a decision subsequent to *Broad*, determined that the trustee had no additional obligation to the terms of the indenture.<sup>139</sup> In *Meckel v. Continental Resources*, the bondholders argued that the trustee had certain obligations regarding the mailing of redemption notices.<sup>140</sup> Although the court could have simply said that the trustee's conduct regarding the notices was reasonable, it instead quoted from the ancient *Hazzard* case.<sup>141</sup> The court identified the *Hazzard* case as a valid precedent for the proposition that the indenture trustee is more like a stakeholder than a traditional trustee.<sup>142</sup> At least one commentator thought this decision was surprising and indicative of the court departing from its own decision in *Dabney*.<sup>143</sup>

Additionally, the court in *Elliott Associates v. J. Henry Schroder Bank & Trust Co.* concluded that there is no implied duty under the TIA to secure greater benefits for bondholders above the specific obligations mentioned in the indenture.<sup>144</sup> The court cited the *Meckel* case for the proposition that the trustee is more like a stakeholder than a trustee, and also explicitly restricted the holding in *Dabney* to cases in which the trustee has an evident conflict of interest.<sup>145</sup>

Clearly, the struggle for an accepted determination of the nature of the relations between bondholders, obligors, and trustees continues. Indeed, one

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<sup>134</sup> See *id.*

<sup>135</sup> See *id.*

<sup>136</sup> See *id.*

<sup>137</sup> *Broad v. Rockwell*, 614 F.2d 418 (5th Cir. 1980), modified on other grounds *en banc*, 642 F.2d 929.

<sup>138</sup> See *id.*

<sup>139</sup> See *Meckel v. Continental Resources Co.*, 758 F.2d 811 (2d Cir. 1985).

<sup>140</sup> *Id.*

<sup>141</sup> See *id.*

<sup>142</sup> See *id.*

<sup>143</sup> See Sklar, *supra* note 121, at 55.

<sup>144</sup> *Elliott Assocs. v. J. Henry Schroder Bank & Trust Co.*, 655 F. Supp 1281, 1288-89 (S.D.N.Y. 1987).

<sup>145</sup> See *id.*

commentator concluded long ago that the indenture trustee cannot be considered a mere stakeholder.<sup>146</sup> The legislative history of the TIA indicates that, at least after default, the highest fiduciary standard is required from the trustee.<sup>147</sup> The legislative comment to the TIA explaining the standard of care states that "[t]he standard provided for is substantially the same as that which is applicable in the field of personal trusts."<sup>148</sup> On the other hand, to consider the trustee as a traditional trustee would be equivalent to overestimating its duties.<sup>149</sup> Even if the conclusion is that the obligation of the indenture lies somewhere between a stakeholder and a trustee it is unsatisfactory as it leaves too much room for uncertainty. It is not clear what qualifications of the indenture trustee should be derived from the traditional trustee and what should be derived from a stakeholder. Thus, bondholders will be confused as to the obligations of the trustee towards them.

Hence, the nature of the indenture is not well defined, and probably combines more than one legal relationship. As stressed above, the nature of the relationships needs to be defined for very practical reasons as both the bondholder and the trustee must know where they stand.

### B. *The Longest Legal Document*

One of the most common complaints regarding a debenture indenture is that it is an unmanageable, long and complex document.<sup>150</sup> Some have called it a "Frankenstein monster," a product of the "excessive sophistication of Wall Street," aimed at confusing the "straightforward and more honest Westerner."<sup>151</sup> As early as 1930, it was named "the largest of all legal documents," and described as an agreement that mystifies young lawyers by its "enormous size and myriad of covenants."<sup>152</sup> Robert Landau opens his book with a milder observation and states "the corporate trust indenture is undoubtedly one of the most involved financial documents that has been devised."<sup>153</sup> A more emotional reaction is of one commentator remarking, "it is only a slight exaggeration to say that nobody loves an indenture."<sup>154</sup>

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<sup>146</sup> See Posner, *supra* note 2, at 198.

<sup>147</sup> See generally H.R. REP. NO. 76-1016 (1939).

<sup>148</sup> H.R. REP. NO. 76-1016, at 55 (1939); see also Obrzut, *supra* note 41, at 141.

<sup>149</sup> See Posner, *supra* note 2, at 198.

<sup>150</sup> See, e.g., Walter H. Brown, *The Mortgage Bond Indenture Forms - 1981*, 36 BUS. LAW. 1017 (1981).

<sup>151</sup> Ray Garret Jr., *A Borrower's View of the Model Corporate Debenture Indenture Provisions*, 21 BUS. LAW. 675, 675 (1966).

<sup>152</sup> Draper, *supra* note 11, at 98.

<sup>153</sup> LANDAU, *supra* note 63, at 7.

<sup>154</sup> Garret, *supra* note 151, at 675.

Indeed, an indenture is of considerable length, rather hard to read, and getting worse. The mortgage agreement drafted in 1880 was almost twice as long as its predecessor, executed in 1871.<sup>155</sup> In fact, it rapidly developed from a modest real estate mortgage, without recitals or covenants to a contract of enormous length.<sup>156</sup> This unpopular development is a result of the slow and gradual evolution of the indenture.<sup>157</sup> The practice has been, and still is, to add new provisions or to elaborate old ones, without any attempt to prune back those that are no longer relevant or are unnecessary for other reasons.<sup>158</sup> Whenever asked to draw an indenture, a lawyer would use a copy of a previous indenture as a starting point, but would usually not erase any of the provisions, knowing it would not cause any harm to leave them.<sup>159</sup> The lawyer would then add some provisions or sentences of her/his own and make a personal contribution to the document.<sup>160</sup> In this way, indenture agreements became larger and larger.

One must acknowledge the relative vacuum created by the absence of substantive legislation or consistent and fully developed jurisprudence. The lack of defined duties and rights makes the contract, namely the indenture, almost an exclusive source of those duties and rights. The comparison of bondholders' rights to shareholders' rights emphasizes this point. As pointed out by Ray Garret, a common stock issue can be created by a single sentence, theoretically speaking.<sup>161</sup> Nevertheless, behind this sentence stands an array of sources: the act under which the issuer was incorporated, the federal securities laws, the rules of a national exchange and an important body of judicial precedents. This cluster of law defines the shareholder's rights in a relatively clear manner. On the other hand, the bondholder has nothing comparable. Generally speaking, his rights derive mostly from the indenture. The TIA speaks in terms of what should be included in an indenture for it to qualify under the Act, rather than creating rights.<sup>162</sup> Therefore, an indenture must be drafted carefully and precisely. From this point of view, an indenture's length presents inconveniences and generates antagonism, yet perhaps it should be accepted as a necessity.

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<sup>155</sup> See Draper, *supra* note 11, at 90.

<sup>156</sup> See Churchill Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551, 552-55 (1965).

<sup>157</sup> See *id.*

<sup>158</sup> See Draper, *supra* note 11, at 94.

<sup>159</sup> See Rodgers, *supra* note 156, at 556.

<sup>160</sup> See *id.*

<sup>161</sup> See Garret, *supra* note 151, at 676.

<sup>162</sup> See *e.g.*, Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 7700o(c) (1997).

Henry Drinker told an anecdote almost 75 years ago about a young lawyer who was determined to compose a workable corporate mortgage.<sup>163</sup> His intention was to create a document of ten to fifteen pages instead of the 150 pages found in his firm's files.<sup>164</sup> The result was that in complete frustration he ended up with a mortgage of even greater length.<sup>165</sup>

### C. Model Indentures

In 1962, the American Bar Foundation (hereinafter "the ABF") announced its plan to develop a model form of corporate debenture indenture.<sup>166</sup> The basic objective of the Advisory Committee was to draft a simple language, workable, and acceptable model.<sup>167</sup> The aspiration was to save lawyers and corporations much effort and expense in the process of the transaction underlying an indenture.<sup>168</sup> In 1965, the model debenture indenture was published and since then its provisions have been widely used.<sup>169</sup> Later, in 1972, the ABF published commentaries on the model analyzing the considerations underlying the Committee's determinations and explaining why a particular form was adopted.<sup>170</sup> It also offered sample alternative provisions that might be appropriate for special circumstances.<sup>171</sup>

One of the cornerstones of the model was the idea of incorporating provisions by reference.<sup>172</sup> The Committee felt this would make the drafting process much more simple and efficient.<sup>173</sup> However, the notion of incorporation did not become a common practice "because of its complexities."<sup>174</sup>

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<sup>163</sup> See Henry S. Drinker, *Concerning Modern Corporate Mortgages*, 74 U. PA. L. REV. 360, 363 (1926).

<sup>164</sup> See *id.*

<sup>165</sup> See *id.*

<sup>166</sup> See Rodgers, *supra* note 156, at 559.

<sup>167</sup> See *id.*

<sup>168</sup> See *id.*

<sup>169</sup> Following this publication, the ABF also issued the Model Debenture Indenture Provisions. AMERICAN BAR FOUNDATION, MODEL INDENTURE PROVISIONS—ALL REGISTERED ISSUES (1997). Although the majority of new issues are offered in registered form, the text was substantially the same as the 1965 model, certainly for the purposes of this study.

<sup>170</sup> See generally AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES (1972).

<sup>171</sup> See *id.*

<sup>172</sup> See Rodgers, *supra* note 156, at 560.

<sup>173</sup> See *id.*

<sup>174</sup> LANDAU, *supra* note 63, at 49. The composers of the model recognized that "...lawyers may prefer a consecutive statement of all the provisions...without reference..." but they still hoped others would adopt the incorporation by reference practice. See Rodgers, *supra* note 156, at 562.

An important concept of the model was its division into two parts: the preprinted standard provisions and the negotiated provisions.<sup>175</sup> The latter was expected to vary greatly from one transaction to the other, therefore, they were left to party negotiation.<sup>176</sup> On the other hand, other provisions, many of them conforming the transaction to the TIA, may be found with little variation in every indenture. Thus, the outcome of the Committee's efforts was a two-part form.<sup>177</sup>

The division into negotiable and non-negotiable provisions might play some role in defending the interests of the bondholders by focusing the negotiating parties on the most important issues, perhaps leading to more demands in favor of the bondholders. Still, it is doubtful that any of the parties would have the incentive to protect the bondholders' interests. Moreover, the Committee's mere classification of provisions as non-negotiable takes into account certain preferences regarding the interests of the parties. Although the Committee stated that the selection was based on the prevailing practice rather than upon any doctrinaire view,<sup>178</sup> it is nevertheless questionable whether such decisions can be made in a truly unbiased manner.

During the drafting process, the Committee received suggestions and comments from numerous experienced lawyers, corporations, and banks nation-wide.<sup>179</sup> Many issuers, investors, and corporate trustees' representatives participated in the meetings and discussions held by the Committee.<sup>180</sup> "[W]ithout question, the model... has been exposed to the most exhaustive, impartial review."<sup>181</sup> In other words, the Committee made a point to hear and take into account the whole spectrum of interests involved in an indenture. Of course, this can be seen from two different perspectives. From one point of view, the involvement of so many experienced people, who represented the different interests surrounding a typical trust indenture, contributed to the elimination of many mistakes, ambiguities and redundancies. However, from another point of view, it would be difficult to deny that this spectrum of interests must have led to many compromises. Although it was clearly important for the model's drafters that it be "as fair and free from bias" as possible,<sup>182</sup> it seems this could not be an impartial document. Any negotiation between parties generates compromises but the

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<sup>175</sup> See *id.* at 560.

<sup>176</sup> See *id.*

<sup>177</sup> See *id.* at 561.

<sup>178</sup> See COMMENTARIES ON INDENTURES, *supra* note 171.

<sup>179</sup> See Rodgers, *supra* note 156, at 562.

<sup>180</sup> See *id.*

<sup>181</sup> Ray, F. Myers, *The Model Indenture*, 104 TRS. & ESTS. 690, 699 (1965).

<sup>182</sup> Rodgers, *supra* note 156, at 568.

question was whether it was wise to adopt compromises regardless of the particular relations between the parties and the specific circumstances of each negotiation. The model provisions were intended to be an exhibit attached to an indenture and therefore it was possible to deviate from the model or omit certain provisions.<sup>183</sup> Yet, if this is to be done, then we are back again at the burdensome pre-model process of drafting an indenture, every lawyer omitting and adding provisions, sentences or words to the model indenture, making it longer and more complicated.

Moreover, as the issue of representing the bondholders themselves is concerned, it seems that the model indenture did not take their interests into full consideration. To be sure, investing banks and corporate trustees were consulted with but, as will be argued later, it is at least doubtful that they were capable of adequately representing bondholders' interests.

Although the ABF model attempted to simplify the complicated language of the indenture, it did not succeed in this specific mission. The Committee's chairman himself admitted that the outcome was a result of compromise.<sup>184</sup> It seems that the involved lawyers were unable to agree on refraining from the use of perfect tenses and a very short sentenced version of the indenture was rejected on the grounds that it was inaccurate, confusing, and unsatisfactory. Chairman Churchill Rodgers acknowledged that the model is not free of superfluous provisions.<sup>185</sup> It was also admitted that the removal of archaic provisions were not significant.<sup>186</sup> Still, the fact that the model contained seventy-five pages should be considered a significant accomplishment. The initial boilerplate was composed of around 100 pages and dozens of lawyers tried to contribute to this document.<sup>187</sup> Under these circumstances, it was quite a success to end up with a document 25 percent shorter.

Even if the model did not achieve the desired standardization, it still plays an important role by being used as a carefully considered standard of comparison. This way, even those who do not use the model as a basis for their indenture can refer to it in search of the appropriateness and adequacy of any provision offered by other parties.<sup>188</sup> The detailed commentaries offered by the model may be helpful to the drafters of any specific indenture, since they explain and analyze many of the provisions.

In 1981, the ABF published another model, the Model Mortgage Bond Indenture Form, which completed the objectives set by the ABF nineteen

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<sup>183</sup> See LANDAU, *supra* note 63, at 49.

<sup>184</sup> See Rodgers, *supra* note 156, at 565.

<sup>185</sup> See *id.*

<sup>186</sup> See *id.* at 564-65.

<sup>187</sup> See *id.* at 561.

<sup>188</sup> See *id.*

years earlier.<sup>189</sup> This form is structured as one integrated document, contrasted with the two-part model indenture. It departed from the model indenture's use of the incorporation-by-reference technique. As mentioned earlier, this technique, despite its theoretical virtues, did not achieve the general acceptance that was expected. The technique's advantages have also decreased with the growing use of "high speed, large-memory, word processing computers."<sup>190</sup>

The Model Mortgage Bond Indenture Form also contains many footnotes providing alternatives to the suggested text, as well as comments, explanations and a cross-reference guide. This model was not what one considers a breakthrough in language simplification. Nevertheless, it was a scholarly and sophisticated effort, aimed to be of practical aid to drafters of indentures.

The next effort to contribute to the field was made in 1983, this time by the American Bar Association's Committee on Developments in Business Financing. This model was named the Model Simplified Indenture, characterizing its modest length (only thirty-one pages) and its use of "plain English."<sup>191</sup> The American Bar Association's Committee declared its desire to make the indenture provisions more comprehensible for the benefit of bondholders, the indenture trustee's personnel, and issuers' officers.<sup>192</sup>

The simplified model, unlike the first ABF model, took the position that nearly all the provisions in the indenture are subject to negotiation at least to some degree. It still attempts to suggest an agreeable language to the main provisions and notes that there are some provisions required by the TIA, which are of course non-negotiable.<sup>193</sup> Some of the achievement of shortening the indenture should be attributed to the fact that the simplified model uses a method of incorporating the TIA by reference. The TIA does not prohibit such incorporation. Moreover, the TIA overrides conflicting provisions in indentures in case they are any. Therefore, the incorporation of the TIA does not affect any of the parties' interests and so it seems like an efficient technique.

Both the first ABF model and the simplified model adopted the limited duties imposed on the trustee under a permissive provision of the TIA on the pre-default situation.<sup>194</sup> In other words, both models require the trustee to

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<sup>189</sup> See AMERICAN BAR FOUNDATION, MODEL MORTGAGE BOND INDENTURE (1981); see also LANDAU, *supra* note 63, at 49.

<sup>190</sup> Brown, *supra* note 150, at 1919.

<sup>191</sup> AMERICAN BAR ASSOCIATION, *Model Simplified Indenture*, 38 BUS. LAW. 741 (1983). The simplified model was prepared for an unsecured convertible subordinated debt.

<sup>192</sup> See *id.*

<sup>193</sup> See *id.* at 742.

<sup>194</sup> See Trust Indenture Act of 1939 § 315(a)(1), 15 U.S.C. § 7700o(a)(1) (1997).

perform only those duties that are explicitly mentioned in the indenture. However, the ABF model deliberately omitted the provision that exempt the trustee from liability for actions taken in good faith, which the trustee believed were authorized or within its powers.<sup>195</sup> The explanation for this omission is that it is unnecessary in light of the overriding provisions of the TIA in matters of the trustee's negligence. The drafters also thought that such an exemption might encourage trustees "to act on the basis of its own good faith and belief rather than on the basis of legal advice."<sup>196</sup> In contrast, the simplified model adopted an additional immunity clause, arguing it will in fact encourage the trustee to act in questionable circumstances instead of refraining from action in an attempt to avoid liability.<sup>197</sup> Of course, in any case, this provision is subject to the TIA.<sup>198</sup> Thus, the approach of these models only attempts to encourage the trustee to act in a certain way and not to change the trustee's legal obligations under the TIA.

In other matters concerning the trustee, it seems that the simplified model and the ABF's model agree. The trustee's duties-and-rights provisions use the same language in both models.<sup>199</sup> The trustee is also exempted in both models from responsibility for the issue and the obligations of the company with regard to the debt features.<sup>200</sup> In *Browning Debenture Holders' Committee v. DASA Corp.*, the Second Circuit Court of Appeals decided that the trustee had no duty to communicate an opinion regarding the fairness of a reduction in the bonds' conversion price to bondholders.<sup>201</sup> The management proposed this offer, which put the bondholders in a better position, in order to encourage them to agree to an amendment of the indenture.<sup>202</sup> The conclusion that the trustee had no duty to monitor the company's compliance with the terms of the conversion privilege conforms with the disclaimer articulated in the models.

As to the question of conflicts of interest, both models take the same view that the trustee may deal with the issuing company and become the owner or pledgee of the bonds.<sup>203</sup> Not surprisingly, the provisions dealing with conflict

<sup>195</sup> See COMMENTARIES ON INDENTURES, *supra* note 171, at 258.

<sup>196</sup> *Id.*

<sup>197</sup> See AMERICAN BAR ASSOCIATION, *Model Simplified Indenture*, 38 BUS. LAW. 741 § 7.01(c) (1983).

<sup>198</sup> See 15 U.S.C. § 7700o(d).

<sup>199</sup> See AMERICAN BAR ASSOCIATION, *Model Simplified Indenture*, 38 BUS. LAW. 741 § 10.17 (1983) and AMERICAN BAR FOUNDATION, *Sample Incorporating Indenture*, MODEL DEBENTURE INDENTURE PROVISIONS § 604 (1965).

<sup>200</sup> See *id.*

<sup>201</sup> *Browning Debenture Holders' Comm. v. DASA Corp.*, 560 F.2d 1078, 1083 (2d Cir. 1977).

<sup>202</sup> See *id.*

<sup>203</sup> See AMERICAN BAR ASSOCIATION, *Model Simplified Indenture*, 38 BUS. LAW. 741 § 7.03 (1983) and AMERICAN BAR FOUNDATION, *Sample Incorporating Indenture*, MODEL DEBENTURE INDENTURE



of interest issues in the models are taken from Section 310(b) of the TIA almost word-by-word. Of course, those provisions are mandatory and regulate the situation whether or not they are incorporated into the indenture.<sup>204</sup> Still, the TIA set the minimum standard and indentures could theoretically adopt provisions that better the bondholders' position. Notice though, that the models' drafters did not point out any additional situations in which conflicts of interest interfere with the relationship between the bondholders and the trustee. Nor did they find any reason to improve the bondholders' position in any other way, such as a shortened waiting period of ninety days in which the trustee must eliminate those conflicts or resign.<sup>205</sup> None of the official parties of the indenture would want to support such voluntary additions as it might inconveniently lead to the termination of relations or accelerate the termination of relations. Only the silent participant in the indenture, the bondholders, might have an opposite interest in this respect. The bondholders might argue that other situations consist of conflicting interests, or, in certain situations, that the waiting period is too long. Still, the bondholders remained silent while these models were drafted. Therefore, the outcome is that both models do not offer the bondholders any improvement in their position as compared to the protection offered in the TIA.

There is no question that the models that were suggested over the years have contributed to the developments in this field.<sup>206</sup> Admittedly, the modern day indenture is not simple and not as standardized as was hoped for. This may be unavoidable due to the fact that this document is a product of lawyers. One commentator said that the indenture draftsmen are often "strong-willed individuals" who may not be satisfied with a model.<sup>207</sup> Those involved in the drafting of indentures often feel a strong need to add to the boilerplate. Moreover, it should be kept in mind that an indenture is subject to many conflicting interests held by at least four parties: the issuer, the underwriter, the trustee, and the bondholders. Surely this contributes to both the length and the verbose sentence structure of the models.

#### D. *The Interests of the Indenture's Parties*

At the foundation of the drafting process of an indenture are the conflicting needs of the parties involved, and therefore the conflicting interests of the

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PROVISIONS § 605 (1965).

<sup>204</sup> See Trust Indenture Act of 1939 § 310(b), 15 U.S.C. § 77jjj(b) (1997).

<sup>205</sup> See *id.* § 77jjj.

<sup>206</sup> Robert Landau further mentions another model, the Sample Uncertified Debt Indenture, offered by the ABA in 1991. See LANDAU, *supra* note 63, at 50.

<sup>207</sup> Brown, *supra* note 150, at 1921.

parties. Issuers insist on maximizing their freedom from burdensome financial and procedural restrictions. In most cases, if not all, they see the indenture as a necessity imposed by law and not as an instrument to create certain business relations. They surely do not treat it as they would treat a regular loan agreement or other private debt. Probably, the issuers regard the indenture as an administrative requirement part of the issuance and underwriting agreement. Since most of the financial conditions and definitions are discussed primarily with the underwriter, the only real interest of the issuer in the indenture is to minimize the administrative burden. In fact, the issuer and the underwriter probably conclude all the financial terms of the bonds before the trustee even enters the picture. The issuer reluctantly agrees to the trustee's role in this relationship and wants the trustee to remain as passive as possible. Seemingly, the trustee's involvement is a burden the issuer must bear, and therefore the issuer strives to minimize such involvement.

The issuer is also the one who formally hires and pays the trustee, since he is the one responsible for qualifying the bond issuance with the TIA.<sup>208</sup> This fact is of great significance. Surely, the character of the relationship in the 19th Century was not one in which the issuer hired the trustee. The TIA itself does not explicitly create such a relationship, but it probably did so unintentionally by making the issuer responsible for the appointment of a trustee in certain issuance scenarios. The trustee is supposed to give services, if at all, to the bondholders, not to the issuer. In sum, not only are the issuer's interests in the indenture focused upon minimizing the supervising power of the trustee, but the structure of the relationship between the issuer and the trustee are distorted and do not serve the bondholders interests.

The underwriter's interests in the indenture are somewhat ambiguous. From one viewpoint, the underwriter acts as a supposed partner of the issuer—it makes suggestions and recommendations and advises the issuer as to market conditions. In this respect, the underwriter is not only a partner to the issuer, but also a partner to the issuance. Arguably, its main interest is that the securities will be marketable. Therefore, the underwriter's principal concern is that the terms of the bonds and the indenture are within the range sufficient to ensure marketability.<sup>209</sup> Thus, the underwriter might be willing to consider the bondholders' interests as far as they coincide with the ultimate goal - to sell those bonds (or to willingly hold them). The conclusion might be that the bonds' attractiveness in the market is the key to the underwriter's course of action.

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<sup>208</sup> See, e.g., 15 U.S.C. § 77eee(a)(1).

<sup>209</sup> See David B. Simpson, *The Drafting of Loan Agreements: A Borrower's Viewpoint*, 28 BUS. LAW. 1161, 1162 (1973).

In contrast, the reality is that in many cases the underwriter is actually holding some of the bonds—either willingly as a chosen investment or unwillingly as a result of poor marketability of those bonds.<sup>210</sup> There is a possibility that the underwriter will not be able to sell those bonds to the public, at least not in the near future. This possibility, even when remote, makes the marketability element more “close to home.” Thus, it arguably puts the underwriter in the position of having specific interests similar, if not identical, to those of the other prospective bondholders. In addition, there is the issue of the underwriter’s reputation. The nature of the securities market induces much reliance on reputation of the involved players. The very ability of the underwriter to sell the securities may depend upon reputation. If losses to bondholders occur repeatedly, the underwriter’s position in the market could deteriorate dramatically and mercilessly. This is especially the case when the underwriter must satisfy institutional investors who commonly participate in many bond issues. These investors are, for the most part, more sophisticated and professional than the average individual investor. Therefore, in order to attract these institutional investors the underwriter must promote an indenture that fits their expectations.<sup>211</sup>

It has been asserted that at least some underwriters feel responsible for the prospective bondholder. Robert Landau acknowledges that the leading investment houses feel “some moral responsibility,” but even he stresses that the primary concern of the underwriter is the marketability of the bonds.<sup>212</sup> Even if some underwriters feel in any way obliged to the bondholders, “the law can hardly leave investors subject to the doubtful protection of private consciences.”<sup>213</sup>

In formulating the TIA, Congress concluded that one of the main disadvantages to bondholders is the absence of representation in the indenture’s drafting process.<sup>214</sup> Yet, even after the TIA was enacted, neither the issuer nor the underwriter provides sufficient representation to bondholders. It must be understood that even the SEC and other agencies do not represent bondholders. The SEC probably relies on the TIA’s provisions to protect bondholders and focuses on the technical inquiry of the indenture’s compatibility with the TIA. This, however, does not adequately protect the interests of bondholders.

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<sup>210</sup> See Benjamin Wham, *Trustees Under Indentures*, 23 A.B.A. J. 179, 181 (1937).

<sup>211</sup> See Garret, *supra* note 151, at 682.

<sup>212</sup> LANDAU, *supra* note 63, at 79.

<sup>213</sup> George E. Palmer, *Trusteeship Under the Trust Indenture*, 41 COLUM. L. REV. 193, 213 (1941).

<sup>214</sup> See Trust Indenture Act of 1939 § 302(a)(6), 15 U.S.C. § 77bbb(a)(6) (1997).

Perhaps the most obvious candidate to be the bondholders' guardian is the trustee. Regrettably, while constructed to protect the bondholders,<sup>215</sup> not even the trustee has a strong incentive to protect bondholders during negotiations. In fact, it would be more reasonable to assume that its only interest in this stage is its own protection from liability.<sup>216</sup> This truth is precisely what inspired passage of the TIA in the first place. Thus, the TIA itself was supposed to be the investor's silent representative in the drafting process of the indenture.<sup>217</sup>

Even if the TIA did not have flaws, it would still be unwise to totally rely on it at the negotiation stage. This is the contractual point where the bondholders could be at their most powerful position, yet they seem to suffer their worst vulnerability. One should not forget that the whole transaction is constructed so that the bondholders will lend money to the issuer. Therefore, it seems reasonable to expect the bondholders to have an advantageous position before they actually lend their money to the issuer. However, somehow, in the end, bondholders are left with a lack of adequate representation, which results in an indenture that does not seem to protect them any more than the TIA dictates. The TIA is only supposed to offer a safety net or minimal protection to bondholders. Although this should not prevent them from achieving better indenture terms, the lack of representation at the negotiation stage does not allow them to do so. In fact, bondholders are effectively prevented from participating in the negotiation of an indenture either directly or indirectly.

Despite the described situation, courts usually characterize indentures as a contract between the issuer and the bondholders asserting that "the connotation is that of a bargained agreement."<sup>218</sup> Consequently, courts tend to deny relief to bondholders if their indenture does not provide the protection they claim.<sup>219</sup> Yet, as argued above, indentures are not bargained for with the bondholders nor is it a product of negotiation. As one court finally acknowledged, "indentures are often not the product of face-to-face negotiations between the ultimate holders and the issuing company... [T]he underwriters ordinarily negotiate the terms of the indentures with the issuers."<sup>220</sup>

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<sup>215</sup> See generally H.R. REP. NO. 76-1016 (1939).

<sup>216</sup> See Obrzut, *supra* note 41, at 135.

<sup>217</sup> See *id.*

<sup>218</sup> Martin Riger, *The Trust Indenture As Bargained Contract: The Persistence of Myth*, 16 J. CORP. L. 211, 214 (1991).

<sup>219</sup> See, e.g., *Elliott Assocs. v. J. Henry Schroder Bank & Trust Co.*, 655 F. Supp. 1281, 1288-89 (S.D.N.Y. 1987).

<sup>220</sup> *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1509 (S.D.N.Y. 1989).

Robert Landau suggests that a number of factors have "substantially resolved this problem."<sup>221</sup> Among them, he notes the increasing influence of institutional investors, the minimum standards of the TIA, the disclosure provision of the 1933 Act, the regulatory powers of the SEC and the patterns of typical indentures.<sup>222</sup> As shown above, these factors are important but still unsatisfactorily protect bondholders during indenture negotiations. While an indenture is a contract binding on the issuer, the trustee, and the bondholders, no party bargains for the rights and protections of the bondholders.

## V. THE PRE-DEFAULT ROLE OF THE TRUSTEE

Most commentators believe that an indenture trustee basically acts in a ministerial role before default has occurred.<sup>223</sup> The TIA itself seems to take that position especially after the TIRA.<sup>224</sup> One significant example of that attitude is the fact that a trustee, who is also a creditor of the issuer, is not prohibited from acting as a trustee until there is a default.<sup>225</sup> This implies that the existence of a conflict of interest in the pre-default situation is not harmful. The conclusion must be that the trustee's role prior to default is merely technical. In addition, under at least some court rulings, trustee duties prior to default are mainly contractual.<sup>226</sup> It has also been said that even the SEC position is consistent with this notion.<sup>227</sup> The SEC's view, as presented in a memorandum supporting the TIRA legislation, was that in the absence of default, trustee duties are essentially ministerial.<sup>228</sup>

In this section, the pre-default role of the trustee will be examined. It will be argued that although some of the duties the trustee bears are merely technical, they – along with more substantive duties – reflect an important and substantial role. From the borrower's point of view, even the technical tasks of the trustee were designed as part of a scheme to protect his rights. As such, not only is the importance of such duties underestimated but so is the question of conflicts of interest in the pre-default situation.

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<sup>221</sup> LANDAU, *supra* note 63, at 79.

<sup>222</sup> *See id.*

<sup>223</sup> *See, e.g.* Friedman, *supra* note 67, at 345, and Stewart M. Robertson, *Debenture Holders and the Indenture Trustee: Controlling Managerial Discretion in the Solvent Enterprise*, 11 HARV. J. L. & PUB. POL'Y 461, 479 (1988).

<sup>224</sup> *See* Trustee Indenture Act of 1939 § 310(b), 15 U.S.C. § 77jjj(b) (1997).

<sup>225</sup> *See id.* § 77jjj(10).

<sup>226</sup> *See, e.g.*, Meckel v. Continental Resources Co., 758 F.2d 811 (2d Cir. 1985).

<sup>227</sup> *See* Joseph F. Kelley, *The Indenture Trustee and Conflict of Interest Concerns*, 378 PLI/REAL 197, 204 (1992).

<sup>228</sup> *See id.*

### A. *The Negotiation Stage*

As described above, the initial stage of preparing an indenture is very important from the bondholders' point of view since it is the indenture that sets out the obligations and rights of the parties involved.<sup>229</sup> The trustee, while primarily concerned with its own interests, is probably the most appropriate party to protect the bondholders' interests at this stage.<sup>230</sup> Unfortunately, the lack of guidance in the TIA and the fact that the investors are not yet "actual" individuals, culminates in most cases to indifferent behavior on the side of the trustee. Moreover, the issuer, sometimes upon the advice of an investment bank or underwriter, usually selects the trustee. Therefore, at this stage the trustee does not feel obliged to the bondholders nor does it have a sense of representing them. It is also not uncommon that the appointment of the trustee takes place almost at the last minute – sometimes only days before closing. This leaves a very narrow timeframe for the trustee to conduct any negotiation for the benefit of the prospective bondholders, if at all. Although the TIA is designed to set minimum standards for the protection of bondholders, it is clear that each issue might be somewhat different and there is always room for negotiation and improvement of the bondholders' position. However, in most cases, there is no actual negotiation regarding bondholder rights. The situation is regrettable not only because bondholder rights might be at stake but also because the trustee itself might be put in a disadvantageous position during the life of the indenture. Although the trustee has no responsibility for the substantive financial provisions of the indenture, it will have to administer the agreement.<sup>231</sup> Therefore, it should be interested in negotiating for provisions that will make its role easier as it confronts problems.

Although negotiating the financial terms of bonds is not one of the trustee's responsibilities, much could be done to improve the bondholders' position. Robert Landau mentions certain procedures that a trustee should follow when reviewing the terms of an indenture.<sup>232</sup> Thus, a trustee should act to eliminate uncertainty and ambiguity from the indenture.<sup>233</sup> For example, it should compare the provisions of the bond itself with the indenture's provisions since in case of conflict the former controls. Another example is the assurance that nothing in the indenture contradicts the TIA. These examinations are for the benefit of bondholders both at the stage when

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<sup>229</sup> See discussion *supra* Part IV(D).

<sup>230</sup> See *id.*

<sup>231</sup> See, e.g., Trust Indenture Act of 1939 § 315(b), 15 U.S.C. § 7700o(b) (1997).

<sup>232</sup> See LANDAU, *supra* note 63, at 81.

<sup>233</sup> See *id.*

investors decide to purchase the bonds and in later developments when the indenture needs to be interpreted by a court. Also, if the bonds are secured, the trustee should give particular attention to the provisions of the indenture that deal with security as this is the bondholders' guarantee that all the details concerning collateral are covered satisfactorily.<sup>234</sup>

### B. Routine Responsibilities

The duties of a trustee prior to default, as defined in Section 315 (a)(1) of the TIA, are only those that are specifically noted in the indenture.<sup>235</sup> In other words, according to the TIA implied duties do not exist in an indenture. Of course, theoretically speaking, an indenture could add to the specific responsibilities of the trustee that are set by the TIA. But as could be presumed, such additional duties are rarely provided, if ever. Thus, a trustee's duties are not broad and are almost always confined to what is specifically mentioned in the TIA.

Moreover, in accordance with Section 315(a)(1) of the TIA, an indenture may provide that the trustee need not make any independent investigation of statements or opinions furnished in conformity with the requirements of the indenture.<sup>236</sup> This provision further emphasizes the notion that trustee duties are restricted and technical in nature.

Section 314(4) of the TIA requires that the obligor file certain reports with the trustee as evidence of compliance with the provisions of the indenture.<sup>237</sup> In the absence of bad faith, trustees may "conclusively" rely on such statements as if they are true.<sup>238</sup> Still, in order to prevent a trustee from serving as a mere "mechanical bookkeeping agent,"<sup>239</sup> the provision requires that the trustee "shall examine the evidence furnished to it...to determine whether or not such evidence conforms to the requirements of the indenture."<sup>240</sup> Thus, a trustee must make sure that there is no evidence indicating a violation of the indenture.<sup>241</sup>

Another responsibility of a trustee is to transmit reports to the bondholders at least once a year.<sup>242</sup> Section 313 of the TIA sets out all the incidents in

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<sup>234</sup> See *id.*

<sup>235</sup> See 15 U.S.C. § 7700o(a)(1).

<sup>236</sup> See Friedman, *supra* note 67, at 346.

<sup>237</sup> See 15 U.S.C. § 77nnn(4).

<sup>238</sup> See *id.*

<sup>239</sup> Friedman, *supra* note 67, at 345.

<sup>240</sup> 15 U.S.C. § 7700o(a).

<sup>241</sup> See Campbell & Zack, *supra* note 103, at 1713.

<sup>242</sup> See 15 U.S.C. § 77mmm.

which such a report is required including any change in the trustee's eligibility status and any advance the trustee made in connection with the bonds.<sup>243</sup> The report is only required at the occurrence of one of the events enumerated in Section 313(a).<sup>244</sup>

Although the language, and in certain points the silence, of the Act certainly corresponds with the view that the pre-default duties of the trustee are minimal, it is nevertheless implied and supported by the legislative history of the Act that the trustee is expected to act in some circumstances.<sup>245</sup> The rationale behind refraining from specifying trustee duties is that neither the Act nor an indenture is capable of giving a recipe for the trustee's conduct in any specific event or condition, as it all depends on particular circumstances.

Still, one should acknowledge the tension between the expectation that the trustee will act and react as necessary and the language of Section 315 maintaining that only explicit duties will be enforced. For example, it is acceptable that a trustee should attempt to ensure that notice of any exchange offer or debt reconstruction is reasonable and complete in light of the facts known so that the bondholders can make an informed investment decision.<sup>246</sup> But it is also agreed that a trustee is not an investment advisor, unless it explicitly undertakes this role. Arguably, if the trustee acts in good faith and conforms with the indenture terms, his behavior will be endorsed by courts, whether passive or active. But notice that due to Section 314(4), it is easier for trustees to rely on the obligor's statements, for example, then to disregard them. Although a court endorsed a trustee's discretion to disregard an obligor's statement in *Cruden v. Bank of New York*,<sup>247</sup> the language of the Act leaves little room to positively require the trustee to use discretion with regard to the obligor's report. In *Cruden*, the trustee was permitted to rely on his counsel's opinion, although that opinion turned out to be wrong.<sup>248</sup> While the plaintiffs contended there was lack of evidence that the trustee had examined and relied upon a counsel's opinion in good faith, the court concluded that there was no evidence of bad faith.<sup>249</sup> The court held that the trustee and the counsel showed "discussion and work between them" and there was no evidence of "lawyer shopping" in an attempt to secure a favorable opinion of counsel.<sup>250</sup>

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<sup>243</sup> See *id.*

<sup>244</sup> *Id.* § 77mmm(a).

<sup>245</sup> See discussion *supra* Part III.

<sup>246</sup> See Barbara Hewson & Jane Hetherington, *The Relationship Between Bondholders and the Indenture Trustee*, 387 PLJ/REAL 633 (1993).

<sup>247</sup> 957 F.2d 961 (2d Cir. 1992).

<sup>248</sup> See *id.* at 965.

<sup>249</sup> See *id.*

<sup>250</sup> *Id.*; see also *Browning Debenture Holders Comm. v. DASA Corp.*, 560 F.2d 1078 (2d Cir. 1977)



### C. *The Standard of Care*

The standard of care required from a trustee prior to default can be characterized as that of negligence: a trustee can be found liable for actions it conducted and omissions to act only if it was negligent. This view is supported by Section 315(d) of the TIA, according to which a trustee cannot be relieved from liability for its own negligence.<sup>251</sup> Section 315(d)(2) assures that a trustee is protected from "any error of judgment made in good faith by a responsible officer..., unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts."<sup>252</sup> After the TIRA, this provision is included in any indenture unless explicitly excluded.<sup>253</sup>

Section 315 was designed to overcome the vast immunities from liability trustees commonly included in indentures.<sup>254</sup> Ironically, Section 315(d)(1) also allows a trustee to avoid liability prior to default in many other situations through Section 315(a), which is an exception under Section 315(d).<sup>255</sup> Section 315(a) states that a trustee is only responsible for explicit duties and that it may rely on the obligor's statements, as long as the trustee acts in good faith.<sup>256</sup> Therefore, a trustee will not be liable in cases where it negligently failed to act, but the action was not expressly required by the indenture. Consequently, the TIA does not really protect bondholders against a negligent trustee.

Section 302(a)(2) of the TIA reiterates the described tension. On the one hand, it notes that the interests of investors will be adversely affected "when the trustee does not have adequate rights and...duties" and that investors may reasonably assume "that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights."<sup>257</sup> On the other hand, it is acknowledged that trust indentures "generally provide that the trustee shall be under no duty to take any [affirmative] action... unless it receives notice of default, demand for action, and indemnity," from the majority of

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(trustee's duties limited to those specifically set forth in the indenture).

<sup>251</sup> See Trust Indenture Act of 1939 § 315(d), 15 U.S.C. § 7700o(d) (1997).

<sup>252</sup> *Id.*

<sup>253</sup> See *id.*

<sup>254</sup> See *id.*

<sup>255</sup> Although theoretically the indenture may expressly provide that Sections 315(a)(1) and 315(a)(2) of the TIA are excluded, it is unlikely to happen due to the disadvantageous position of bondholders during the negotiation stage.

<sup>256</sup> See 15 U.S.C. § 7700o(a).

<sup>257</sup> *Id.* § 77ccc(a)(2).

bondholders.<sup>258</sup> Moreover, an indenture "generally relieves the trustee from liability even for its own negligent action or failure to act."<sup>259</sup>

Therefore, the standard of care required from the trustee prior to default is actually less than negligence. It seems that only acts or failures-to-act conducted *in bad faith* could lead to trustee liability.

The structure of the TIA, together with the fact that only default activates a passive trustee, is problematic. While making it difficult to find a trustee liable for a failure to act in the pre-default period, the structure has even more severe consequences where bondholders are concerned. The Act creates a significant obstacle to a trustee's perceived responsibility to discover defaults before they occur.

When default occurs, it is in many occasions too late for bondholders to save their investment. This is certainly true when the bonds are unsecured. But even secured bonds usually do not guarantee return on the investment since the value of property rapidly deteriorates once the owner defaults. Also, secured creditors are not entitled to compensation for delay caused by an automatic stay in foreclosing on collateral when the claim is under-secured.<sup>260</sup> Indeed, the notice of default usually means that bondholders are in the worst possible financial position. Creditors of the obligor, most of them with secured loans or having other priority over the bondholders, are acting forcefully even before the first bondholder committee is convened. It is only prior to default that bondholder investment could still be saved with vigorous intervention. Prior to default, bondholders can negotiate with the obligor for terms that will make them better off, in case default does occur. Once default notice has been served, bondholders are placed in the position of having nothing to lose. Occasionally, the obligor's officers will take advantage of that position in order to achieve legally binding concessions from bondholders. Therefore, the importance of an early detection of default cannot be overstated.

Yet a trustee is not encouraged by either the TIA or the indenture to do anything that could lead to such early discovery of a possible default. It allows a trustee to rely on statements by the obligor, with minimal requirements of investigation that could lead to the discovery of impending default.<sup>261</sup> In the case of *Caplin v. Marine Midland Grace Trust*, the obligor was under the duty to maintain a ratio of assets to liabilities of 200 percent at

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<sup>258</sup> *Id.*

<sup>259</sup> *Id.*

<sup>260</sup> See *United Sav. Ass'n of Texas, Ltd. v. Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 375 (1988).

<sup>261</sup> See 15 U.S.C. § 7700o(a).

all times and it submitted certifications to that effect.<sup>262</sup> If Section 315(a) means that the trustee shall accept this statement without question, there is no doubt the bondholders are in potential trouble. Admittedly, a passive trustee is not equipped — through either the TIA or the indentures — to police compliance with the complex covenants commonly used in indentures which are designed to protect bondholders.<sup>263</sup>

Furthermore, the TIA's division of a trustee's role between passive pre-default and active post-default creates another problem. Since upon default a trustee's duties increase, the question is whether the trustee becomes absolutely liable under a higher degree of care as default occurs, and what shall be the consequences of a default occurring without the trustee's knowledge or reasonable awareness. Defining default as occurring only after the trustee is notified commonly solves this problem.<sup>264</sup> Thus, in practice, there is almost no situation in which default can occur without the trustee's knowledge.

#### D. Controlling Managerial Discretion

Following the problematic issue of discovering default before it occurs, the question arises of whether it is at all possible. More precisely, is it possible to supervise an obligor's conduct and managerial decision-making process? Should the management of an obligor inform bondholders of managerial moves or allow any interventions, and if so, to what extent? Finally, does the obligor's management owe any fiduciary obligations to bondholders?

In order to answer these questions, the nature of the relationship between bondholders and obligors should be compared with the relationship of obligors with shareholders. While both bondholders and shareholders supply obligors with capital, their interests can be adverse. Bondholders have a fixed claim on the obligor's assets, set at specific times, and shareholders have only an unfixed residual claim.<sup>265</sup> Although shareholders might earn a dividend, they are not entitled to it and must totally rely on the management in that respect.<sup>266</sup> Their rights are also subordinate to the prior rights of creditors.<sup>267</sup> These

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<sup>262</sup> Caplin v. Marine Midland Grace Trust, 439 F.2d 118 (2d Cir. 1971).

<sup>263</sup> See Friedman, *supra* note 67, at 348.

<sup>264</sup> See AMERICAN BAR FOUNDATION, *Sample Incorporating Indenture*, MODEL DEBENTURE INDENTURE PROVISIONS § 601(a)(2) (1965) (requires notice to the trustee in order for default to occur in all cases, except for failure to pay principle or interest, bankruptcy, or similar proceeding involving the obligor).

<sup>265</sup> See Corey W. McDaniel, *Bondholders and the Corporate Governance*, 41 BUS. LAW. 413, 418 (1986).

<sup>266</sup> See Robertson, *supra* note 223, at 463.

<sup>267</sup> See McDaniel, *supra* note 265.

major differences between bondholders and shareholders lead to two important observations. First, bondholders, as creditors, have the right to force the obligor into bankruptcy upon default.<sup>268</sup> Shareholders have no such right. Second, shareholders' reliance on management is so broad that management is charged with a fiduciary duty to act in the best interests of the shareholders.<sup>269</sup> No fiduciary duty as such is owed to creditors.

The duty of management to shareholders might lead to a direct clash of interests between shareholders and bondholders.<sup>270</sup> In fact, the implementation of that duty occasionally causes management to engage in strategies that will benefit shareholders at the expense of bondholders.<sup>271</sup> For example, management can decide to enter into a high-risk project, presuming success will benefit shareholders while failure will not harm them. In fact, shareholders prefer riskier strategies that will lead to higher dividends.<sup>272</sup> In contrast, such risky moves are clearly against bondholder interests, as it might increase the number of creditors with a higher priority, raise the cost of capital for the corporation, and eventually might lead to default.<sup>273</sup> Therefore, this strategy might lessen the probability that bondholders will be able to recover from the issuer assets. Generally speaking, bondholders prefer that earnings will be reasonable while the company pursues a conservative business strategy "which would maximize the likelihood that the corporation will have sufficient funds to repay its debts."<sup>274</sup> As rational bondholders realize the danger that lies in the pursuit for larger dividends, they might seek to control managerial discretion.<sup>275</sup>

Surely, the initial and more natural way of attaining such control of managerial performance would be within a contractual relationship, namely,

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<sup>268</sup> See Robertson, *supra* note 223, at 463.

<sup>269</sup> See George Corey et al., *Are Bondholders Owed a Fiduciary Duty?*, 18 FLA. ST. U. L. REV. 971 (1991).

<sup>270</sup> The word "management" in this section includes both the board of directors and the corporation's officers. Although there may be subtle distinctions between the duties of corporate directors and officers, they are not significant for the purposes of this paper. See Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1168 n.8 (1990).

<sup>271</sup> See Robertson, *supra* note 223, at 463; see also Michael C. Jensen & William H. Meckling, *Theory of The Firm: Managerial Behavior, Agency Cost and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 255-63 (5th ed. 1993); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

<sup>272</sup> See Corey, *supra* note 269, at 974.

<sup>273</sup> See *id.*

<sup>274</sup> Kahan & Klausner, *supra* note 10, at 938.

<sup>275</sup> See Robertson, *supra* note 223, at 463.

the indenture. Typically, bondholders wish to constrain three possible activities.

The first activity is the distribution of dividends to shareholders, which from the bondholder point of view, is a mere reduction of the obligor's assets. This danger is usually addressed by including in the indenture limitations on the management's ability to make cash distributions. Since it can be relatively easy to define, this constraint is also the most effective one. Many indentures provide that cash dividends can only be made from a specific pool of funds that represent superfluous profit.<sup>276</sup> Since dividend restrictions are relatively easy to define, and since the process of paying cash dividends is controlled by certain regulations, the limitation on obligor's management is not complicated. Nevertheless, such restrictions are not as common as they are in standard loan agreements.<sup>277</sup> For example, restricted payments covenants, which limit dividends and stock repurchases, are found in over 90 percent of private loan agreements, but in only 20 to 50 percent of public bond indentures.<sup>278</sup>

The second management strategy that bondholders fear is debt dilution.<sup>279</sup> Management may weaken present creditor claims by issuing subsequent senior debt.<sup>280</sup> Most investors deal with that risk by including a negative pledge clause in the indenture.<sup>281</sup> Negative pledge covenants range from total prohibition on subsequent borrowing to detailed prohibitions on every mortgage, lien, charge or encumbrance, with specific inclusions and exclusions.<sup>282</sup> Another possibility is to restrict the amount of the outstanding debt of the issuer.<sup>283</sup> Since the issuer's interest is to have flexibility in its practice, the scope of negative pledge covenants depends on the negotiation process. A survey conducted in 1984 indicated that 82 out of 100 companies had negative pledge clauses in their indentures.<sup>284</sup>

It is still difficult and costly to monitor issuer indebtedness. Although the financial statements are available to the public, a close and strict supervision on management is needed to effectively prevent the issuer from creating senior debt. In addition, it would not be practical for individual bondholders to monitor the creation of senior debt. Therefore, a trustee should conduct such monitoring. Yet no specific provisions in indentures provide for such disruptive activity on the side of the trustee. But even if we assume a negative

<sup>276</sup> See *id.* at 466.

<sup>277</sup> See Amihud, *supra* note 74, at 463.

<sup>278</sup> See *id.*

<sup>279</sup> See, e.g., Corey, *supra* note 269, at 974.

<sup>280</sup> See Robertson, *supra* note 223, at 466.

<sup>281</sup> See *id.* at 467.

<sup>282</sup> See COMMENTARIES ON INDENTURES, *supra* note 171, at 351.

<sup>283</sup> See, e.g., Robertson, *supra* note 223, at 467.

<sup>284</sup> See McDaniel, *supra* note 265, at 425.

pledge clause is enforced against management, it must be recognized that its scope may not be sufficient. In other words, a typical negative pledge clause will probably not cover all the possible ways of diluting the value of bondholder claims. The ABF Commentaries on Model Indenture points out some alternative dilution methods. For example, the effect of a prior lien may be achieved if a company sells and leases back any real property (with or without repurchase agreement). The party who bought the property has an interest in it prior to any unsecured rights of bondholders.<sup>285</sup> Another example is priority of a subsidiary's property. Debt issued by a subsidiary of an obligor generates a claim against the assets of the subsidiary that is prior to the equity claims of the parent corporation.<sup>286</sup> Although almost all the familiar dilution methods can be addressed in the indenture, it is not only complicated and costly but is also not very likely to happen due to the position of the bondholders in the negotiation process.

Secured debt might solve the problem of monitoring issuer debt, since then one would only need to monitor transactions made with respect to secured assets. As this might be true, the influence of the interest rate should be taken into consideration. Bondholders who insist on secured debt undertake lower risk and therefore their compensation is reflected in lower interest rates. This price, however, might be too high for certain investors and does not necessarily present an adequate solution to the issue of debt dilution. In fact, although ex-post priority of secured creditors affects the ex-ante perspective of unsecured creditors, only fairness concerns are minimized and not efficiency concerns.<sup>287</sup> Thus, unsecured creditors will tend to refrain from monitoring management or terminating on default.<sup>288</sup> In addition, a secured creditor, who is supposed to monitor an obligor's misbehavior, might refrain from doing so "because its collateral is entirely dissipated, although other assets can still be salvaged."<sup>289</sup> Therefore, the fact that debt could be secured does not completely address the problems of managerial misbehavior.

Still, trying to prevent the dilution of bondholder claims can be more manageable than attempting to tamper with the risk profile of an issuer.<sup>290</sup> In entering a high-risk activity, issuers favor shareholders at the expense of bondholders. When bondholders fix the terms of their debt, those terms reflect a certain risk of the business. A subsequent increase in the risk of an

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<sup>285</sup> See COMMENTARIES ON INDENTURES, *supra* note 171, at 355.

<sup>286</sup> See *id.* at 357.

<sup>287</sup> See F.H. Buckley, *The Termination Decision*, 61 UMKC L. REV. 243, 245 (1991).

<sup>288</sup> See *id.* at 287.

<sup>289</sup> Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 58 (1982).

<sup>290</sup> See Robertson, *supra* note 223, at 467.

issuer actually decreases the funds from which bondholder claims can be obtained. Monitoring the risk level of management decisions, the projects management enters into, and the new debt management undertakes is not only extremely costly, but also virtually impracticable. One would probably need to sit in on every board of directors meeting. So even assuming a risky decision will be identified, it will probably be followed by legal proceedings. The interpretation of such a provision calling for such monitoring in a court would be very difficult. Furthermore, it would be absurd to bring a suit on every managerial decision that seems risky. In fact, bondholders would probably be better off without a contractual provision attempting to restrict risky conduct. As with every contractual provision, such a provision might harm bondholders in cases of unforeseen circumstances. If no such provision exists, a court might treat their interests more favorably, as it will not be limited by the indenture's language. Additionally, although theoretically possible, it would be extremely difficult to amend an indenture after unwanted conduct of management has been detected. Naturally, such amendments are hard to achieve in even normal relationships where the parties are able to represent their interests adequately. It would be even more difficult in light of the disadvantageous position bondholders find themselves in during the negotiation and drafting of an indenture agreement.

Indeed, one of the indicators that management does not seem to be truly restricted by an indenture's provisions or by bondholder interest is the downgrading of bond ratings.<sup>291</sup> These downgrades reflect the increased risk those firms bear.<sup>292</sup> In 1986, Standard & Poor's rating agency downgraded 364 corporate debt issues while upgrading only 149.<sup>293</sup> Thus, bondholders are forced to bear higher risk than they were willing to at the time they initially invested their money.

The conclusion should be that indentures, as a contractual tool determining bondholder rights, do not provide bondholders sufficient protection against transfers of wealth to stockholders. As indicated in a report issued by Fortune magazine in 1984, the trend in the market is away from including too many restrictions in bonds.<sup>294</sup> It was suggested that the retreat from bond covenants could be attributed to the long life of issues and the difficulty of amending indentures.<sup>295</sup> One commentator stated that indentures "[do] not and cannot

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<sup>291</sup> See *id.* at 471.

<sup>292</sup> See *id.*

<sup>293</sup> See *id.*

<sup>294</sup> See FORTUNE, Apr. 29, 1985, at 266. The exception to this trend is the "negative pledge clause" which is still used by senior debtholders.

<sup>295</sup> See Corey, *supra* note 269, at 976.

protect bondholders."<sup>296</sup> According to his view, changes in the bond market in the last decades, such as enormous market growth, modern takeover atmosphere and lower-quality issues, emphasizes the need for further protection to bondholders. Many scholars insist that the complexity of indentures makes it too costly and inadequate in "its ability to foresee, and therefore guard against, potential bondholders hazards."<sup>297</sup>

### E. Fiduciary Duty to Bondholders

The imposition of fiduciary duties in respect of bondholders as a solution to the problem of transferring wealth from stockholders to bondholders has long been debated.<sup>298</sup> A fiduciary duty is usually referred to in the context of what directors owe to a corporation and to shareholders. A fiduciary duty is a duty of "the finest loyalty."<sup>299</sup> It was famously described by Justice Cardozo as "not honesty alone, but the punctilio of an honor the most sensitive."<sup>300</sup> A fiduciary duty is generally thought of as encompassing both a duty of loyalty and a duty of care.<sup>301</sup> Those duties commonly require that a director will act without faithlessness or self-dealing while affirmatively protecting the interests of the corporation through informed decisions.<sup>302</sup>

The idea that corporate directors owe a fiduciary duty to bondholders originated in 1939 in the decision of *Pepper v. Litton*.<sup>303</sup> The case involved a corporation that became insolvent, but still was not declared bankrupt.<sup>304</sup> In this frequently cited decision, the U.S. Supreme Court held that a stockholder was prohibited from acting in his own benefit and to the detriment of creditors.<sup>305</sup> The Court determined that a "fiduciary obligation is designed for the protection of the entire community of interests in the corporation—

<sup>296</sup> McDaniel, *supra* note 265, at 413.

<sup>297</sup> Thomas E. Stagg & Scott Ferretti, *Contractual Protection: An Existing Remedy For Bondholder Distress*, 4 ST. JOHN'S J. LEGAL COMMENT. 245, 264 (1989).

<sup>298</sup> See generally William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Reconstructing*, DUKE L.J. (1989), and William W. Bratton, *The Interperation of Contracts Governing Corporate Debt Relationships*, 5 CARDOZO L. REV. 371 (1984). It is not the purpose of this discussion to fully explore the question of imposing fiduciary duties towards bondholders.

<sup>299</sup> John C. Carter, *The Fiduciary Rights of Shareholders*, 29 WM. & MARY L. REV. 823, 824 (1988).

<sup>300</sup> See *Meinhard v. Salmon*, 164 N.E. 545, 546 (1928).

<sup>301</sup> See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 179 (Del. 1985).

<sup>302</sup> See Nancy T. Oliver, *Fiduciary Obligations to Holders of Convertible Debentures: Simons v. Cogan*, 549 A.2d 300 (Del. 1988), 58 U. CIN. L. REV. 751, 754-55 (1989).

<sup>303</sup> *Pepper v. Litton*, 308 U.S. 295 (1939).

<sup>304</sup> See *id.* at 307.

<sup>305</sup> See *id.*



creditors as well as stockholders."<sup>306</sup> Subsequent cases seem to adopt the holding of *Pepper*. For example, in *Green v. Hamilton*, the court relied on the decision in *Pepper* and included the bondholders in "the entire community of interests in the corporation."<sup>307</sup> However, this statement was in dicta, as the court held that convertible bondholders had a cause of action based on fraud.<sup>308</sup> In other cases, courts have created a construction in which the directors owed a fiduciary duty to bondholders, but this duty was derived from the indenture.<sup>309</sup> This suggests that courts imposed a lesser contractual standard of good faith and not necessarily the higher standard of fiduciary duty.<sup>310</sup> Additionally, although the *Pepper* holding seemed to provide for fiduciary duties owed to bondholders, it must be recognized that the context of the case was that of bankruptcy,<sup>311</sup> or at least insolvency. In this context, it is appropriate to be reminded of the "trust fund doctrine." According to this doctrine upon insolvency directors no longer owe a duty to stockholders; instead, they owe their duty to the corporation's creditors. As only insolvency triggers that doctrine, and since *Pepper* was decided under a factual situation of insolvency, it only applies to post-insolvency cases.<sup>312</sup>

Moreover, many courts have forcefully argued that contract law, rather than corporate fiduciary law, should be the basis for bondholder protection. In fact, it was the traditional position of courts that creditors, including bondholders, should protect themselves with proper provisions in their contracts. Thus, courts typically declined to extend fiduciary protection to bondholders.<sup>313</sup> This was also true regarding convertible bonds, where the holder is allowed to convert debt into equity.

In *Harff v. Kerkorian*, the court held that "debenture holders are not stockholders and their rights are determined by their contract."<sup>314</sup> In *Pittsburgh Terminal v. Baltimore & Ohio R.R.*, convertible-bondholders

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<sup>306</sup> *Id.*

<sup>307</sup> *Green v. Hamilton*, 437 F. Supp. 723 (S.D.N.Y. 1977).

<sup>308</sup> *See id.*

<sup>309</sup> *See Broad v. Rockwell Int'l Corp.*, 642 F.2d 929 (5th Cir. 1981) (en banc); *Gardner & Florence Call Cowles Found. v. Empire Inc.*, 589 F. Supp. 669 (S.D.N.Y. 1984), *vacated on other grounds*, 754 F.2d 478 (2d Cir. 1985).

<sup>310</sup> *See Stagg & Ferretti, supra* note 297, at 261.

<sup>311</sup> *See id.* at 257.

<sup>312</sup> In *Pepper*, the court held that the debt owed by the corporation to one of its directors, an insider debt, was subordinated to the other debts of the corporation in accordance with the "cardinal principles of equity jurisprudence." *See Pepper*, 308 U.S. at 306.

<sup>313</sup> *See William W. Bratton, Jr., The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 668 (1984).

<sup>314</sup> *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975). Kerkorian was a director and controlling shareholder of Metro-Goldwyn-Mayer (MGM).

attacked a corporation's failure to notify them of a dividend payment to shareholders.<sup>315</sup> Although one of the judges in the panel claimed that fiduciary duties to bondholders might exist, the other two members of the panel specifically disclaimed such a notion.<sup>316</sup> Ultimately, the court's opinion was based on the contract and the implied covenant of good faith.<sup>317</sup> In *Simons v. Cogan*, a supplemental indenture was issued as a consequence of a merger between two related companies.<sup>318</sup> The supplement determined that the bonds would no longer be convertible to common stock on a one-to-one basis, but rather they would be convertible based on the fixed price of the stock under the merger deal, which was \$12.<sup>319</sup> Since the principal amount of each bond was \$19.20, this move reflected substantial losses to the bondholders and they sued for breach of contract, breach of fiduciary duty, and fraud.<sup>320</sup> The Delaware court rejected the claim under breach of fiduciary duty stating that the bondholders were not owed such duty.<sup>321</sup> Instead, the rights of the bondholders were to be determined by their contract, and by the covenant of good faith, in limited occasions.<sup>322</sup> It was emphasized that the good faith covenant must not be confused with a fiduciary duty.<sup>323</sup> In addition, the court refused to give any significance to the fact that the bonds were convertible into stock at the holder's choice.<sup>324</sup> Thus, as long as the right to convert is not exercised, the holder of the option to convert is the creditor of the company.<sup>325</sup> The court said that the bondholder, prior to conversion, does not face the risks, which the fiduciary duty was designed to address.<sup>326</sup>

Another appealing argument for rejecting the notion of fiduciary duty owed to bondholders is the critical difference between bondholder and stockholder interests. Determining that management owes fiduciary duties to both bondholders and stockholders creates a difficulty in situations that certain decisions would benefit one group while harming the other. One interesting

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<sup>315</sup> *Pittsburgh Terminal v. Baltimore & Ohio R.R.*, 680 F.2d 933 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982).

<sup>316</sup> *See id.*

<sup>317</sup> *See id.*

<sup>318</sup> *Simons v. Cogan*, 542 A.2d 785, 787 (Del. Ch. 1987). *Cogan* controlled Knoll International Inc.

<sup>319</sup> *See id.*

<sup>320</sup> *See id.*

<sup>321</sup> *See id.* at 786, 791.

<sup>322</sup> *See id.* at 787.

<sup>323</sup> *See id.*; *see also Katz v. Oak Industries, Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986) (while rejecting the existence of fiduciary duties owed to bondholders, the court held that there is a duty of good faith and fair dealing that arises from the contract and the intentions of the contracting parties).

<sup>324</sup> *See Simons*, 542 A.2d at 788.

<sup>325</sup> *See id.* at 788-89.

<sup>326</sup> *See id.*

case that emphasizes this potential dilemma is the case of *Revlon v. MacAndrews*, which involved an attempt to acquire Revlon by a hostile tender offer made by Pantry Pride.<sup>327</sup> In response, Revlon bought approximately a third of its own stock in exchange for subordinated notes. In order to deter Pantry Pride from acquiring Revlon with junk bond financing,<sup>328</sup> the notes included covenants restricting the ability of diluting the debt. However, during a negotiation with another potential buyer of its stocks, Revlon waived those restrictive covenants in exchange for the promise of a higher interest rate.<sup>329</sup> Still, Pantry Pride ultimately topped the other offer, and the noteholders were left without protection against dilution.<sup>330</sup> The court held that the directors of Revlon breached their fiduciary duty to the shareholders by making concessions "out of concern to their liability to the noteholders, rather than maximizing the sale price of the company for the stockholders benefit."<sup>331</sup> The court in *Revlon* stated that the noteholders' rights were determined by contract and the fiduciary duty to stockholders prevailed.<sup>332</sup> But what should Revlon have done if the directors owed a fiduciary duty to both the noteholders and the stockholders? It is clear that putting the bondholders and stockholders in the same position with regard to the fiduciary duties owed by the directors is problematic as a practical matter. It seems that the inevitable conflict between the interests of the two groups does not allow — at least practically — equal protection by a fiduciary duty.

#### F. *The Case of Leveraged Buyouts and Takeovers*

Court refusal to endow bondholders with fiduciary rights was sustained through the takeover market of the 1980s, which featured conditions hostile to bondholders. During the eighties it became more and more common for companies to be involved in mergers, acquisitions, leveraged buyouts, and recapitalizations for numerous objectives.<sup>333</sup> These kinds of transactions, usually backed by a leveraged recapitalization, increased shareholder wealth at the expense of bondholders.<sup>334</sup> If a company involved in a risky project borrows money to redeem stock, the surviving shareholders can expect to be

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<sup>327</sup> *Revlon v. MacAndrews*, 506 A.2d 173 (Del. 1986).

<sup>328</sup> The term "junk bonds" commonly refers to high-yield and high-risk bonds rated "Ba" and below by Moody's Investors Services or "BB" and below by Standard & Poor's. See McDaniel, *supra* note 266, at 415.

<sup>329</sup> See *Revlon*, 506 A.2d at 178.

<sup>330</sup> See *id.*

<sup>331</sup> See *id.* at 179.

<sup>332</sup> See *id.* at 182.

<sup>333</sup> See Kahan & Klausner, *supra* note 10, at 933 n.2.

<sup>334</sup> See *id.* at 948-49.

benefited without bearing any risk. On the other hand, the bondholders would face a company with a higher level of risk and chance of failure, while gaining nothing if the company succeeds. Of course, theoretically, bondholders could have demanded higher interest rates that would compensate for this greater risk, but even if they managed to do that at the negotiating point, they could never really predict the level of risk that the company chooses to bear in the future.

From 1984 to 1988, bonds of 183 companies lost value as a result of mergers, acquisitions, and leveraged buyouts.<sup>335</sup> Forty-five of these companies had their bonds downgraded by Moody's Investors Service from investment grade to speculative grade.<sup>336</sup> Recapitalizations, which often occurred in the face of a takeover threat, adversely affected the bonds of ninety other corporations.<sup>337</sup>

In an environment in which takeovers, mergers and acquisitions are expected, the disparities of interest between holders of stocks and holders of debt are accentuated.<sup>338</sup> Although such transactions often earn large gains for shareholders, it is usually at the expense of bondholders and other unsecured creditors. One famous example is the case of RJR Nabisco, which announced in 1988 what was at that time the largest leveraged buyout in history.<sup>339</sup> The company's bonds dropped overnight by about 20 percent and their Moody's rating was reduced from 'A' to 'Caa' resulting in bondholder losses of around \$1 billion.<sup>340</sup> As a consequence, Metropolitan Life Insurance Company claimed it lost \$40 million on its investment in those bonds, although it was assessed at the same time that Metropolitan gained over \$20 million on its RJR Nabisco stock holdings.<sup>341</sup> Thus, it was widely argued that those leveraged deals make bonds riskier and prompts stronger protection of bondholders through indenture provisions.<sup>342</sup>

Companies that wanted to raise capital by issuing bonds were forced to accommodate bondholder fears. A "change of control covenant" was developed, according to which the bondholders had the right to either sell the bonds to the company at a predetermined price, or to have the interest rate

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<sup>335</sup> See *id.* at 933 n.2.

<sup>336</sup> See *id.*

<sup>337</sup> See *id.*

<sup>338</sup> See Oliver, *supra* note 302, at 770.

<sup>339</sup> See Kahan & Klausner, *supra* note 10, at 972.

<sup>340</sup> See *id.* at 932.

<sup>341</sup> See Christopher Farrell et al., *Bondholders are Mad as Hell – and They're Not Going to Take It Anymore*, BUS. WK., Feb. 6, 1989, at 82.

<sup>342</sup> See Matthew Winkler, *Wall Street Is Devising the Takeover-Proof Bond*, WALL ST. J., Nov. 3, 1988, at C1.

increased.<sup>343</sup> The triggering incident is usually the acquisition of more than a certain percentage of company shares or a downgrading in the bond's credit rating, or both. Those provisions were also labeled as "event risk covenants" or "poison pills."<sup>344</sup> The latter label reflects their role of deterring potential buyers of the company.

The question is whether change of control provisions gives bondholders sufficient protection. First, we must hope that these provisions are well drafted, so that they will be violated in every case where wealth is transferred from bondholders to shareholders. The definition of the triggering event should be simple and encompassing. Still, it must be understood that not every risky situation can be predicted, especially when dealing with a contract that is expected to endure for decades.

Second, it must be noted that the issuer management will tend to object to the inclusion of such change of control provisions in the indenture. Whereas, it has been suggested that management and bondholder interests in such protective provisions coincide,<sup>345</sup> there are opposite contentions. The basic argument is that management is equally interested in deterring hostile acquisitions, and therefore it is motivated to include control change provisions in the indenture.<sup>346</sup> However, management's primary concern is the personal loss of position as a result of a hostile takeover. Thus, management could support a friendly acquisition.<sup>347</sup> Moreover, when management wants to increase leverage in order to deter hostile takeovers, it certainly has a conflict of interest with bondholders. A covenant that covers only hostile acquisitions is not sufficient from the bondholders' point of view.<sup>348</sup> In addition, management would probably prefer to take other actions against hostile bids in order to allow itself an unlimited process of decision-making.<sup>349</sup> An empirical study covering 122 bonds with change of control covenants between 1986 and 1991 illustrated that only 10 percent were "oriented solely toward bondholder protection."<sup>350</sup> In the other 90 percent, a managerial interest was present.<sup>351</sup> Therefore, the different interest of management and bondholders brings the negotiation issue back to the spotlight. As argued above, as long as bondholders are poorly represented at the negotiation stage, management

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<sup>343</sup> See Kahan & Klausner, *supra* note 10, at 934.

<sup>344</sup> See *id.*

<sup>345</sup> See John C. Coffee, *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990).

<sup>346</sup> See *id.* at 1519-20.

<sup>347</sup> See Kahan & Klausner, *supra* note 10, at 949.

<sup>348</sup> See *id.*

<sup>349</sup> See *id.*

<sup>350</sup> *Id.* at 968.

<sup>351</sup> See *id.* at 969.

interest will probably prevail. Thus no or at least insufficient protection will be provided to bondholders.

Third, the phenomenon of control covenants turned out to be temporary. By the first half of the 1990s, when takeover activity declined, the use of change of control provisions declined dramatically, although surely still in the interest of bondholders.<sup>352</sup> Moreover, customary merger techniques have a similar effect on a company's debt portfolio. The same could be said of repurchases of an issuer's outstanding shares, as well as other restructuring techniques that are sometimes financed by new junk bond debt.<sup>353</sup> Indeed, the end of the leveraged buyout boom does not reflect the receding of bondholder risk. One example is the Marriott spin-off that occurred in 1992. Marriott Corporation notes were issued at par in April 1992 and traded at 110 afterwards. Yet those notes became junk bonds immediately following the announcement of the spin-off, trading at 80 by the end of October 1992.<sup>354</sup> "[Similar] trend[s] will surely continue as long as opportunism exists to expropriate value from bondholders."<sup>355</sup> In light of this reality, the suggestion to increase bondholder awareness of the danger and the market pressure on issuers and underwriters to include protective provisions in indentures seem insufficient, if not plainly naive.<sup>356</sup> Refraining from using change of control provisions, which has occurred lately, shows not only that bondholders do not have the power to protect themselves. It also illustrates that the contractual protection solution is insufficient in the context of bondholder rights.

### G. A Pre-Default Activated Trustee as a Solution

A trustee is in a good position to protect the bondholders from unwanted management decisions. One of the TIA's primary purposes was to establish an entity that would enable bondholders to overcome the disadvantageous position of a widely dispersed class—the difficulty of the collective action problem. If a trustee could act in accordance with the common interest of bondholders during a pre-default situation, it would definitely improve their position — both during the negotiation of contractual protections and during the life of the bond, when monitoring management activities is required. In

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<sup>352</sup> See *id.* at 978. While \$156 billion was paid for acquisitions of public companies in 1988, it fell to \$122 billion in 1989, \$48 billion in 1990 and \$32 billion in 1991.

<sup>353</sup> See Riger, *supra* note 218, at 213.

<sup>354</sup> See F. John Stark et al., "Marriott Risk": A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders, 5 COLUM. BUS. L. REV 503 (1994).

<sup>355</sup> *Id.* at 506.

<sup>356</sup> See Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J.L. & COM. 187, 195 (1991).

other words, the suggested solution is an "activated trustee" that is encouraged to play a part in the formation of the indenture, and a continuing part in monitoring the conduct and financial position of the issuer.<sup>357</sup> The ideal trustee is one that is truly a representative of the bondholders—one that is acting as if conducting its own affairs, as if the bonds were issued in its name and as if its own money was at stake.

The activated trustee suggestion is not free of difficulties. First, all the arguments concerning the bondholders' inability to enforce indenture provisions apply also to the activated trustee, as these arguments were not based on the number and dispersion of the bondholders. Thus, the trustee will encounter difficulties in both identifying unwanted actions and forcing management to avoid them. Another discouraging factor is the definition and perception of the role of the trustee in an indenture. As mentioned above, the trustee's role is only seen as administrative. An administrative agent cannot be expected to initiate interventions in the managerial decision process. The TIA and indentures do not encourage such behavior by the trustee. In this respect the interests of the trustee and the issuer coincide. A second factor, which makes it less likely that the activated trustee will have an interest in controlling managerial discretion, is the fear of liability. As was historically true, trustees sometime found themselves more engaged in protecting themselves than in protecting bondholders. Indeed, it seems that the widest exposure of a trustee is when both bondholders and the issuer feel injured. Trustee reliance on issuer declarations and counsel opinions, as allowed by the TIA,<sup>358</sup> encourages a trustee to remain passive, hiding behind the TIA's provisions.

A startling example of a dangerously passive trustee was the dramatic default of the Washington Public Power Supply System Nuclear Projects 4 and 5. The projects, held by 88 participating cities, were terminated in 1983 before completion, causing the bondholders losses of \$7.2 billion.<sup>359</sup> The court found that the participating cities lacked the statutory authority to issue the bonds, and therefore, under the ultra vires doctrine, these bonds were void.<sup>360</sup> This fiasco not only raised the financial costs of municipal borrowers, but also raised questions regarding the role of trustees prior to default.<sup>361</sup>

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<sup>357</sup> See Friedman, *supra* note 67, at 356.

<sup>358</sup> See Trust Indenture Act of 1939 § 314(4), 15 U.S.C. § 77nnn(4) (1997).

<sup>359</sup> See Dan Fischer, *WPPSS and Hammersmith: Increased Credit Risk Protection Resulting From Unprecedented Defaults*, 9 ARIZ. J. INT'L & COMP. L. 513 (1992).

<sup>360</sup> See *Chemical Bank v. Washington Pub. Power Supply Sys.*, 666 P.2d 329 (Wash. 1983), *cert. denied*, 471 U.S. 1065 (1985).

<sup>361</sup> See Theodore J. Sawicki, *The Washington Public Power Supply System Bond Default: Expanding the Preventive Role of the Indenture Trustee*, 34 EMORY L.J. 157, 159 (1985).

However, things could be at least a little different if the trustee was viewed as an active protector of bondholders. In fact, if a trustee is forced to act as a prudent person "in the conduct of his own affairs" in pre-default situations,<sup>362</sup> then the legal status of the bonds will be more thoroughly examined prior to issuance. It is indisputable that the more a trustee can act as a single creditor of the issuer, the more it will be able to detect major flaws in the issue and monitor certain actions of issuer management. Just like any other large creditor, it could monitor the issuer's conduct and the issuer's ability to pay debt at any given time. It could also monitor the managerial decision-making process.

To accommodate such a change, the TIA would have to be amended to provide the trustee with the necessary tools. Those amendments would have to put the trustee in a position where it can have access to the issuers' decision-making processes. It should have the ability to use independent experts, like accountants and lawyers, to investigate suspected decisions made by management. It should also have reasonable access to information concerning such decisions. In other words, full cooperation between the trustee and the issuer would have to be achieved, as is often the case when the creditor is a large bank, an institutional investor, or other private-debt lender. Of course, a balance must be found so that the independence of the issuer will not be interfered with in a way that would be a detriment both to the company and to the bondholders. Creative ways must be designed in order to assure the trustee's ability to monitor the issuer's management without a brutal intervention in the business considerations of the company. In order to avoid such a trap, the trustee's new powers should resemble those of an accountant or financial consultant who is in a position to advise the company, or a potential buyer of the company, as to its financial position. This means it will *not* have the authority to intervene in decisions, as it should *not* have any voting rights in board of directors meetings. Yet the most important effect would be reporting suspect conduct to the bondholders. In turn, the bondholders should be the ones to determine whether their rights have been violated. In other words, the trustee should look for suspect actions and situations, investigate such actions and situations with the aid of independent counselors, and disclose the results of the investigation to the bondholders. To avoid making such reports to the bondholders a warning sign to the market, a frequent pre-scheduled reporting system should be developed. If this process is well backed by legislation, it should eventually lessen bondholder risk. Surely these activities would make the trustee more attuned to indications

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As the standard of care required from the trustee after default. See 15 U.S.C. § 7700o(c).



of possible failure, and thus allow bondholders to protect their interests before it is too late.

The most essential change would be to motivate the trustee to participate effectively in the negotiation of the indenture. If the trustee is judged at this early stage as a prudent person "in the conduct of his own affairs,"<sup>363</sup> it might be motivated to actively participate in the negotiation and truly represent the prospective bondholders.

Although this suggestion requires a mini-revolution in the pre-default role of trustees, it would be consistent with the general role of trustees as protectors of bondholders against conflicting interests of issuer management and shareholders. That is why putting the trustee in an activated position is preferable over the suggested third party representative, although such a third party could implement the task just as well.<sup>364</sup> The activated trustee would also be consistent with the courts' refusals to recognize a fiduciary duty owed to bondholders. As argued above, such a duty is not desirable and bondholders should rely on their indenture as a source of their rights. The suggestion to re-define the trustee's pre-default role would allow the continuation of using a contractual protection model — this time with real content.

Once again, it must be emphasized that the suggestion presented here is not free of flaws. First, the trustee will need more professional advice, since specialized advice will be required in order to accomplish the task. The activated trustee also faces a higher risk of being sued. Therefore, it will necessarily lead the trustee to charge more for its services. The question is whether that additional sum will outweigh the present value of possible losses bondholders expect to bear due to managerial opportunism.<sup>365</sup> In other words, this could be a price that bondholders — and society — need to pay in order to achieve the goals set by the TIA.

As for the increased risk of suits against the trustee, originating from both bondholders and issuers, there are at least two mitigating observations. First, the additional payment to the trustee should cover the additional risk. But, more to the point, the prudent person standard is not a very high standard of care. After all, the trustee is not responsible for the misconduct of the issuer, and it is only required to act as a prudent person. The standard of care should be reasonable foreseeability. A reminder should be made too, that this standard of care is less stringent than that of the Barkley Bill, which preceded the TIA.<sup>366</sup> The proposed provision in the Bill required that the trustee act as

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<sup>363</sup> *Id.*

<sup>364</sup> See Corey, *supra* note 269, at 981.

<sup>365</sup> See Robertson, *supra* note 223, at 485-86.

<sup>366</sup> See discussion *supra* Part III(A).

a prudent person who is a fiduciary possessing the degree of skill of a trustee.<sup>367</sup> According to that proposal, if the trustee introduces itself as having a higher degree of skill than it actually has, then the higher level will set the standard under which the prudent person should be examined.<sup>368</sup> A lesser standard was eventually adopted by the TIA.<sup>369</sup> An emphasis should also be given to the second part of the standard, the duty of the trustee to act as if it conducts its own affairs. As this should be the test, it is possible that the trustee will be able to rely on reports of independent agents. Yet it would be less sensible to completely trust issuer reports. In any case, after the courts define the scope of liability of the redefined role of the trustee, it would clarify what is to be expected from such trustees.

One must also acknowledge that the redefinition of the trustee's role will not solve all the problems discussed above, such as the ability of creditors to predict certain transactions in the modern market environment. If a trustee that exercises the standard of care required could not predict an unknown mechanism that has the effect of diluting bondholder debt, then it cannot be held liable for it. Still, in such a scenario, bondholders will face losses due to the flow of wealth from them to the shareholders. However, the redefinition of the trustee role should have a positive effect on the indenture as a bargain between the issuer and the bondholders, and therefore the bondholders would be better protected at least against known hazards.

Although there are some drawbacks in the pre-default imposition of the prudent person standard upon trustees, it is still a suggestion that would improve the position of bondholders dramatically, and enable them to act and react almost as a single creditor. By lending money, creditors, including bondholders, assume risk and that action cannot be risk-free. Therefore, a reasonable level of risk will be well tolerated by bondholders. It is only the *excess* exposure to management discretion that this suggestion attempts to address.

The conclusion should be clear: as long as the trustee's pre-default role is administrative and passive, the trustee is less likely to be in a position to control managerial discretion in order to protect bondholders from managerial opportunism. Yet, if the basic perception is changed, and trustees assume a more active role, it is possible not only to monitor management conduct, but also to detect warnings about a prospective default. This, of course, will dramatically improve the bondholders' position and increase the likelihood that they will see their investment back.

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<sup>367</sup> See Johnson, *supra* note 41, at 111.

<sup>368</sup> See *id.*

<sup>369</sup> See Trust Indenture Act of 1939 § 315(c), 15 U.S.C. § 7700o(c) (1997).

## VI. CONFLICT OF INTEREST CONCERNS

The question of conflict of interest between trustees and bondholders is perhaps the most debated issue in this field. As mentioned before, one of the main purposes of the TIA was to eliminate any possible conflict of interest, so that a disinterested trustee will perform its duty to bondholders in the best possible way. The SEC's report that preceded the TIA enactment expressed dismay at the common practice of creating some sort of alliance between trustees and obligors.<sup>370</sup> It was argued that, when conflicting interests were involved, "the trustee will be either unwilling or unable to look at the situation objectively."<sup>371</sup> An example of the problem, originally described in the report, was the case of R.H. Hoe & Company.<sup>372</sup> Guaranty Trust Company was the trustee of bonds issued by Hoe.<sup>373</sup> The relationship between Guaranty and Hoe was so entangled as to be inconceivable from a modern perspective. Guaranty was not only a creditor of Hoe, having lent \$1,700,000, it was also in control of Hoe through common stocks and voting trust rights.<sup>374</sup> In addition, an affiliate of Guaranty was an underwriter of Hoe's securities.<sup>375</sup> This situation led to an intense conflict of interest even before default occurred.<sup>376</sup> Once it appeared that Hoe was in financial difficulty, Guaranty moved to decrease its loan and increase its collateral through a modification to the loan agreement.<sup>377</sup> A modification would not have been possible if Guaranty did not have control over Hoe's board of directors, which in turn meant fewer assets were available for the bondholders.<sup>378</sup> Needless to say, Guaranty did not inform the bondholders of the impending default.<sup>379</sup>

The TIA dealt with the problem of conflicts of interest through Section 310(b).<sup>380</sup> This section sets limitations on the trustee's qualifications, deriving from situations of conflicting interests.<sup>381</sup> In originally nine and currently ten

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<sup>370</sup> See Friedman, *supra* note 67, at 330.

<sup>371</sup> Johnson, *supra* note 41, at 102.

<sup>372</sup> See SEC Report, *supra* note 53, at 39-42, 83-88.

<sup>373</sup> See *id.*

<sup>374</sup> See *id.*

<sup>375</sup> See *id.*

<sup>376</sup> See *id.*

<sup>377</sup> See *id.*

<sup>378</sup> See Friedman, *supra* note 67, at 333.

<sup>379</sup> See SEC Report, *supra* note 53.

<sup>380</sup> See Trust Indenture Act of 1939 § 310(b), 15 U.S.C. § 77jjj(b) (1997)

<sup>381</sup> See *id.*

subsections, "the Act specifies in meticulous detail the conditions under which a trustee is deemed to have a conflict of interest."<sup>382</sup>

Section 310(b)(1) determines that a potential conflict of interest exists if the trustee is also acting as a trustee under other indentures of the same obligor.<sup>383</sup> The rationale is to prevent a situation in which, upon default, the trustee represents the two bondholder groups, with adverse interests. There are two main exceptions set by the Act where no such conflict of interest is likely to exist and in such situations one trustee could act under two indentures of the same obligor. First, it is not considered a conflict when one indenture is the collateral of the other.<sup>384</sup> In this situation the two indentures are assumed to have the same interest, since the value of one indenture is dependent on the other. The second exception is made for unsecured and equally ranked issues, with no differences that would make them likely to conflict.<sup>385</sup> Here too, no conflict is likely to arise, but the SEC may still prohibit such situations if it finds otherwise.<sup>386</sup>

A potential conflict of interest is also recognized when the trustee, or any of its directors or executive officers, is also an obligor or underwriter.<sup>387</sup> The prohibition here is clear, as being a debtor and a trustee for the creditor is problematic, and the underwriter might have close ties to the issuer's management.<sup>388</sup> For the same reason, the trustee cannot directly or indirectly control or be controlled by the obligor or the underwriter.<sup>389</sup>

Section 310(b)(4) to the TIA determines that if the trustee or more than one of its directors or executive officers is a director, officer, employee or representative of the obligor or the underwriter, a conflict of interest exists.<sup>390</sup> That means that only one director or executive officer of the trustee can be a director or executive officer of the obligor. Yet, that representative of the trustee cannot be an executive officer of both the obligor and the trustee. It can be an executive officer in one and a director in the other. In addition, in case the trustee has more than nine directors, it can appoint an additional director as an obligor's director, so two representatives of the trustee sit in a high position at the obligor's top management.<sup>391</sup> This provision allows the trustee to have one or two representatives on the board of directors of the obligor,

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<sup>382</sup> Friedman, *supra* note 67, at 333.

<sup>383</sup> See 15 U.S.C. § 77jjj(b)(1).

<sup>384</sup> See *id.* § 77jjj(b)(1)(A).

<sup>385</sup> See *id.* § 77jjj(b)(1)(C).

<sup>386</sup> See *id.* § 77jjj(b)(1)(i).

<sup>387</sup> See *id.* § 77jjj(b)(2).

<sup>388</sup> See Friedman, *supra* note 67, at 334.

<sup>389</sup> See 15 U.S.C. § 77jjj(b)(3).

<sup>390</sup> See *id.* § 77jjj(b)(4).

<sup>391</sup> See *id.* § 77jjj(b)(4)(B).

which might be problematic. The drafters of this provision were concerned that the obligor might attempt to interfere with the trustee's decisions concerning the bondholders, but were nevertheless willing to allow some possible influence.

Subsection 5 to Subsection 9 of Section 310(b) involve the ownership of voting securities in the trustee, the obligor and an affiliate or parent company of the obligor.<sup>392</sup> The Act determined specific percentages, above which a conflict of interest is assumed.<sup>393</sup>

Section 310(b)(10) prohibits the trustee from being or becoming a creditor of the obligor.<sup>394</sup> Although the problematic position of a creditor-trustee was discussed prior to the TIA's legislation, it was *not* originally regarded a conflicting interest under Section 310(b). The only original reference to a creditor-trustee was in Section 311. The provision did not prohibit such relationship outright, but rather stated that the trustee may not retain for its own benefit any payments it received in its capacity as a creditor of the obligor within four months before a default in payment occurred. Such funds must be set aside and shared with the bondholders. Many scholars attacked the failure to define the case of a creditor-trustee as one of the situations where conflict of interest occurs.<sup>395</sup> In *York v. Guaranty Trust Co.*, a creditor-trustee participated in the reorganization plan of an obligor instead of forcing the obligor to liquidate, which led to a very small amount of assets left for those bondholders who did not join the reorganization.<sup>396</sup> The court held that the trustee failed to force liquidation upon the obligor because it was interested in protecting its own position as a creditor.<sup>397</sup> Although the TIA did not prohibit the trustee from being a creditor of the obligor, the court decided that the trustee's inaction under the belief that it would be benefited by it was a breach of the trustee's obligations.<sup>398</sup> A few other cases, already mentioned, illustrate the courts' attitudes towards the creditor-trustee, despite the lack of explicit direction from Congress.

The prohibition against a creditor-trustee conflict was one of the main innovations of the TIRA. The nature of the trusteeship under the TIA was such that many trustees were banks or affiliates of banks.<sup>399</sup> This reality led on the one hand to a greater probability that a trustee would be or become a

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<sup>392</sup> *Id.* §§ 77jjj(b)(5)-77jjj(b)(9).

<sup>393</sup> *See id.*

<sup>394</sup> *Id.* § 77jjj(b)(10).

<sup>395</sup> *See, e.g.*, Obrzut, *supra* note 41, at 132; Campbell & Zack, *supra* note 103, at 1705.

<sup>396</sup> *York v. Guaranty Trust Co.*, 143 F.2d 503 (2d Cir. 1944), *rev'd on other grounds*, 326 U.S. 99 (1945).

<sup>397</sup> *See id.*

<sup>398</sup> *See id.* at 513-14.

<sup>399</sup> *See Kelley, supra* note 227, at 199.

creditor of the issuer, especially in light of customary syndicated loans.<sup>400</sup> On the other hand, the powerful banks were aggressively attempting to influence Congress to avoid "tying their hands."<sup>401</sup> The outcome reflected a compromise between these two forces. Indeed, the TIRA included the creditor-trustee in the list of prohibited conflicting interest.<sup>402</sup> But the emphasis must be made that the prohibition is only exercised when there is default.<sup>403</sup>

The most important part of Section 310(b) turned out to be the timing of activating the conflict of interests limitations rather than the definitions of the conflicting interest situations. The original TIA determined that once a trustee fell under one of the then nine possible situations of Section 310(b), the trustee was disqualified.<sup>404</sup> In such a case, the trustee either had to eliminate the conflicting interest or resign within ninety days after discovering the conflict.<sup>405</sup> If the trustee failed to take either of those steps, it had to notify the bondholders, who then had the power to obtain a court order to remove the trustee from office.<sup>406</sup> Of course, this prerogative did not relieve the trustee from its duty to remove any conflict.

The TIRA changed this situation dramatically, reinforcing the notion that the trustee's pre-default role is merely ministerial.<sup>407</sup> Thus, the TIRA provided that the trustee might continue to serve as such, notwithstanding the existence of a conflict of interest, so long as there has been no default.<sup>408</sup> The rationale behind this construction was that prior to default the harm is only potential and not actual. The current requirement sets a post-default conflict of interest standard. Upon default, the trustee has 90 days to eliminate the conflicting interest.<sup>409</sup> If the default is not cured during this time, the trustee must resign.<sup>410</sup>

In accordance with the discussion of the trustee's pre-default role, the distinction the TIA made between pre-default and post-default conflict of interest is not to the benefit of bondholders. As argued above, in the pre-default situation, entities with conflicting interests might attempt to transfer

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<sup>400</sup> See *id.* at 201.

<sup>401</sup> *Id.* at 199.

<sup>402</sup> See Trust Indenture Act of 1939 § 310(b)(10), 15 U.S.C. § 77jj(b)(10) (1997).

<sup>403</sup> See *id.* § 77jjj(b)(i).

<sup>404</sup> See *id.* § 77jjj(b).

<sup>405</sup> See *id.*

<sup>406</sup> See *id.*

<sup>407</sup> See Kelley, *supra* note 227, at 204.

<sup>408</sup> There is an exception that the obligor and its affiliates cannot serve as trustees for its own securities. See 15 U.S.C. § 77jjj(a)(5).

<sup>409</sup> See *id.* § 77jjj(b).

<sup>410</sup> See *id.*

wealth from the bondholders.<sup>411</sup> Although the discussion was focused on the issuer's shareholders, it is also applicable to managerial decisions to transfer wealth from other interested parties such as other creditors. If the trustee is a creditor of the obligor, the obligor is capable of making decisions that will transfer wealth from the bondholders to the trustee – and that can take place prior to default.

The postponement of the elimination of conflicting interest until default occurs has two disturbing aspects. First, the conflicting interest might further worsen the bondholders' position during the negotiations of the indenture. If at that time the trustee is a creditor of the issuer or serves as a trustee for another indenture of the same obligor, or in another conflict of interest with the prospective bondholders, it is not too difficult to see that the position of the bondholders is inferior. The trustee would then be even less willing to aggressively represent the bondholders. This situation puts both the trustee and the bondholders in an impossible position, where conflicting interests are supposed to be ignored and a community of interests is assumed to subsist. One striking example is the clear interest of a creditor-trustee to subordinate the obligations held by bondholders. Such subordination assures that the trustee is treated as a senior creditor able to receive "double dividends" from an insolvent obligor's estate.<sup>412</sup> It is clear that the willingness of a creditor-trustee to include a subordinated debt provision in the indenture is in contrast to the bondholders' interests. It is obvious why the creditor-trustee will not even attempt to negotiate a better position for the obligations to the bondholders.

Second, the effect on the pre-default situation may also be seen as contrary to the bondholders' interests. As explained, the conflict of interest can be maintained while no default occurred. The subordinated debt example can be used in this context as well, only in the converse situation. Where the bonds are superior to obligations held by the creditor-trustee, the conflict is still serious. If the obligor will face financial difficulties, the creditor-trustee self interest will be to act immediately, where as the bondholders' priority will call for more patient conduct, hoping that the obligor's position will improve.<sup>413</sup> This creates a situation in which the junior creditor — the creditor-trustee — might harass the senior creditor — the bondholders — into paying out the junior creditor and thereby "to turn the subordination upside down."<sup>414</sup> It is

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<sup>411</sup> See discussion *supra* Part V(D).

<sup>412</sup> See Campbell & Zack, *supra* note 103, at 1718. The "double dividend" refers to the senior creditors' right to both their own allocated share and the share allocated to junior debt, until the senior debt is paid. See *id.* at 1719.

<sup>413</sup> See *id.* at 1720.

<sup>414</sup> PHILIP R. WOOD, *THE LAW OF SUBORDINATED DEBT* 56 (1990).

therefore clear, that even before default a distressing conflict of interest may occur.

Marking the default as an activating point was based on the assumption that a trustee's role pre-default is ministerial and that bondholders' rights are not offended.<sup>415</sup> Both points are disputable. It has already been argued extensively why a trustee's pre-default role is not and should not be merely administrative for the sake of bondholders. In addition, the potential danger of a conflict of interest is risky by definition — assuming that one who operates in an environment of conflicting risks has his judgment distorted by selfish criteria — even unwillingly. As Philip Wood had put it, “[t]he foundation is not actual injury to beneficiaries but the hallowed orison ‘lead us not into temptation.’”<sup>416</sup> It is not clear why legislators as well as courts endorsed the perception that only *actual* conflict of interest should be alarming. It is also well recognized in case law that pre-default allegations “have been addressed in a number of cases.”<sup>417</sup> As described in the SEC's report from 1936, in the case of Hoe, Guaranty — the trustee — was acting on its behalf as Hoe's creditor *before* default occurred.<sup>418</sup> There is no reason to ignore the possible claims of bondholders deriving from pre-default conduct of the trustee.

Indeed, the case law established under common law was not overruled by the TIRA. Therefore, the holdings of *Elliott Associates* and *Hutton*, as discussed earlier, are still applicable. However, in order to find the conflicting interest forbidden, those cases require an active step made by the trustee for its own benefit and to the detriment of bondholders. Although those cases better addressed the bondholders' interests than the TIA does, this position is not sufficient. First, aware of courts' views, trustees can disguise their actions. More importantly, the requirement of action encourages the trustee to be passive even when the bondholders' interests mandate action. “[Trustees] seldom can, or do, take positive steps to protect investors. When a [t]rustee's other interests and duties arising from other capacities indicate that it would be best not to act, subsequent inaction raises the reference that the inaction was caused by such other interests and duties.”<sup>419</sup> In other words, the inaction of the trustee might be driven by a conflict of interest. According to the case law it is not clear that such trustee's behavior will be condemned.

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<sup>415</sup> See Friedman, *supra* note 67, at 345.

<sup>416</sup> See WOOD, *supra* note 414, at 98.

<sup>417</sup> Friedman, *supra* note 67, at 204.

<sup>418</sup> See SEC Report, *supra* note 53, at 39-42, 83-88.

<sup>419</sup> Campbell & Zack, *supra* note 103, at 1717.



Moreover, waiting for default in order to replace a self-interested trustee is detrimental to bondholders in the sense that it would be a bad time to replace a trustee. The bondholders will lose an informed trustee and experience has shown there are difficulties to find a replacement trustee at this point.<sup>420</sup> Therefore, scenarios such as these will probably have "an adverse effect on the efficiency of bondholders' representation."<sup>421</sup>

## VII. THE POST-DEFAULT ROLE OF THE TRUSTEE

Many believe that the post-default role of the trustee "provides the greatest test of the corporate trust officer's skill and expertise."<sup>422</sup> There is no doubt that one of the main purposes of this trusteeship was to provide a representative to the bondholders in the case of default, as their disparity might constitute an obstacle for exercising their rights in such situations.<sup>423</sup> The default is considered to be the primary concern of bondholders, as their investment is at stake, especially in the common case of an unsecured debt. As many aspects of default have already been addressed above,<sup>424</sup> this section concentrates on the definition of default in indentures and on the responsibilities of trustees after default with a special note regarding the trustee's role in the case of bankruptcy proceedings.

### A. Defining Default

The term "default" used throughout indentures is significant and, therefore, must be carefully defined in order to avoid confusion and uncertainty. Indentures contain a detailed clause regarding the events of default.<sup>425</sup> By now, it must be clear that the definition of default is not a merely technical factor, but rather constitutes a determination of the trustee's role, and mostly of the bondholders' rights.

Generally speaking, the events of default are designed to reflect a high probability that future payments of principal and interest will be jeopardized. If such high probability is detected, the bondholders must promptly act in an attempt to assure payment and sue the obligor if necessary.

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<sup>420</sup> See WOOD, *supra* note 414, at 100.

<sup>421</sup> Kelley, *supra* note 227, at 213.

<sup>422</sup> LANDAU, *supra* note 63, at 173.

<sup>423</sup> See Johnson, *supra* note 41, at 92.

<sup>424</sup> See discussion *supra* Part VI.

<sup>425</sup> See Friedman, *supra* note 67, at 347.

Defaults in the payment of principal or interest are always considered serious and give rise to the remedial provisions.<sup>426</sup> Some indentures provide for a 30-day grace period in the case of a failure to pay interest on the due date, as the ABF model suggests.<sup>427</sup> But even Robert Landau asserts that no grace period should be provided because of the "serious nature of this type of default" and because it is very unlikely to happen due to mere carelessness.<sup>428</sup> One should also be reminded that the trustee's right to withhold notices of default under certain circumstances does not apply to this case, and the trustee must act immediately.<sup>429</sup>

It is also quite common to include in the default definition a failure to pay principal or interest on any or some of the other indebtedness of the issuer.<sup>430</sup> This failure might indicate a financial stress and therefore it is desirable, but still most indentures give in this case generous grace periods to allow the cure of the default.<sup>431</sup> Some even require the "ripening of the default" and an acceleration by the holders of the other indebtedness.<sup>432</sup> In the same way, other obligations of the issuer, prior in lien to the lien of the bonds, are to be adequately managed. A breach in those obligations is considered a default, since the interest of the subordinated debt holders is concerned.<sup>433</sup> For example, if the payment of the prior-lien bonds is not delivered and the senior creditors react inefficiently, junior bondholders are adversely affected. The chance of being able to redeem the investment through the lien decreases when the prior lien debt is not settled, since the priority will be used to pay the other bondholders. The bondholders will prefer to rely on the lien rather than on the emptying funds of the issuer and therefore need to be able to interfere when a prior-lien debt defaults.

In addition, the breach of the indenture by the obligor is bound to lead to default. Of course, there are many covenants in the indenture that are not critical and at least in some situations may be considered minor breaches. The ABF Commentaries on Model Indentures acknowledges this issue by suggesting that when the obligor fails to supply a particular financial report, "it is not necessarily an indication that the payment of the [bonds] is in

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<sup>426</sup> See LANDAU, *supra* note 63, at 173.

<sup>427</sup> See *id.*

<sup>428</sup> See *id.* at 75. Similarly, the failure to make other payments due to the bondholders, such as a sinking fund payment, are also considered under the default definition, only a grace period is usually provided for these. See *id.* at 174.

<sup>429</sup> See Trust Indenture Act of 1939 § 315(b), 15 U.S.C. § 7700o(b) (1997).

<sup>430</sup> See COMMENTARIES ON INDENTURES, *supra* note 171, at 215.

<sup>431</sup> See *id.*

<sup>432</sup> See *id.*

<sup>433</sup> See *id.*

jeopardy."<sup>434</sup> Although this failure might indicate that the issuer is in some sort of distress, and may even be concealing what it considers to be negative data, it would not be sensible to define all breaches as default. Therefore, it is customarily provided that the trustee or a specified percentage of the bondholders shall give formal written notice to the issuer—plus a grace period—before a default occurs in such cases.<sup>435</sup> It might be suggested that certain limited numbers of covenants, besides the payment of principal and interest, should be defined as serious breaches that do not require such a long wait before any action can be made. For example, the negative pledge covenant, prohibiting the creation of prior liens, might be included in such a category. That would certainly encourage issuers to put those covenants on a high priority, and it will enable the bondholders to act immediately when they feel their investment is in serious jeopardy. The inclusion of certain provisions in such a category depends on the power of the bondholders during the negotiation process.

Two more instances are considered an event of default. These are the voluntary and involuntary adjudication of the issuer as bankrupt. This includes consent to enter an order for relief against it, consent to appoint a custodian for its property or, under state law, making a general assignment for the benefit of its creditors. A default is also triggered by a court order under any bankruptcy law or an order of liquidation. The condition is that any of the instances remain without a stay and in effect for sixty days. This gives the issuer a fair opportunity to act for the dismissal of the bankruptcy proceedings.

Another recommended event that should be defined as default, although not so commonly done, is the failure of the issuer to satisfy a substantial final judgment. The fact that the issuer is not able to pay as the judgment determined might indicate trouble. Notice that the unsatisfied judgment may result in a lien on the issuer's assets,<sup>436</sup> which might be prohibited by the indenture and therefore lead to default under one of the other events.<sup>437</sup>

According to Section 315(b) of the TIA, the trustee shall give the bondholders notice of all defaults "known to the trustee," within ninety days after it occurred.<sup>438</sup> The language of the provision suggests that the trustee has no duty to identify events of default. Thus, a passive trustee in the pre-default situation is under no obligation to search for signs and indications of a default.

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<sup>434</sup> *Id.*

<sup>435</sup> *See id.*

<sup>436</sup> *See, e.g.,* N.Y. C.P.L.R. LAW § 5203 (McKinney 1997) (a judgment creates lien on local real estate).

<sup>437</sup> *See* COMMENTARIES ON INDENTURES, *supra* note 171, at 213.

<sup>438</sup> *See* Trust Indenture Act of § 1939(b), 15 U.S.C. § 7700o(b) (1997).

Yet the trustee does not have immunity against negligent conduct,<sup>439</sup> so it must be sure to have access to information that a reasonable person would have. The trustee is also given the discretion to refrain from notifying the bondholders of a default, where withholding such a notice is in the interest of the bondholders.<sup>440</sup> If there is a possibility of curing the default, then "too hasty action in publicizing the default can cause irreparable damage."<sup>441</sup> Section 315(b) requires that the decision of withholding a notice will be taken by the trustee's top management and in good faith.<sup>442</sup>

A remark should be made regarding the grace period given to the issuer after a breach of the indenture. Although the grace period usually serves both the issuer's interest and the bondholders' interests, this is not always the case. In some situations, the bondholders' investment will have better chances to survive a default if a grace period is provided. The hope is that during the grace period the default will somehow be cured. In contrast, there might be certain situations, in which the grace period will have the effect of worsening the bondholders' position. In such cases, the trustee should have the right to "move promptly."<sup>443</sup> For now, such flexibility will only be provided in the indenture if the trustee so insists.

A final note in this regard would be that differing opinions as to the interpretation of the definition of an event of default might arise. The contrasting interests of the trustee as a representative of the bondholders from one hand and of the issuer on the other hand are likely to lead to disagreements in this respect. Surely the issuer will contend that a certain situation is not included in the definition of default, while there are grounds to think otherwise. This might raise issues of conflict of interest between the trustee and the bondholders, although there is no assurance that the triggering default event has occurred. Of course, the trustee must ignore any personal interest it has in the obligor. The trustee should therefore continuously examine its position regarding those definitions and impartially enforce this position. The trustee should be ready to pursue a declaratory judgment action against the issuer in that respect.

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<sup>439</sup> See *id.* § 77000(a).

<sup>440</sup> See *id.* § 77000(b).

<sup>441</sup> LANDAU, *supra* note 63, at 184.

<sup>442</sup> See 15 U.S.C. § 77000(b).

<sup>443</sup> LANDAU, *supra* note 63, at 175.

### B. *The Trustee's Responsibility*

Prior to the TIA's enactment, the trusteeship was conceived as a mechanism that allowed the bondholders to act with a unitary voice.<sup>444</sup> This conception led to two provisions commonly included in indentures. The first was a very broad exculpatory clause relieving the trustee from liability unless guilty of gross negligence or willful misconduct.<sup>445</sup> The second provision stated that only a majority of bondholders would be able to initiate the activation of the trustee.<sup>446</sup> In other words, it was customary that a specific percentage of bondholders should send the trustee an official demand to enforce their rights according to the indenture.

The TIA established a new standard the trustee must follow after default.<sup>447</sup> The trustee had to exercise powers as indicated in the indenture and use the same degree of care and skill as a prudent person would exercise under similar circumstances in the conduct of its own affairs.<sup>448</sup> After the TIRA this standard became legislatively mandated.<sup>449</sup>

Robert Landau asserts that, despite the prudent person standard set by the TIA, the trustee still has limited powers.<sup>450</sup> The argument is that while a prudent person managing his own affairs "can take *any* action that seems to be indicated by the circumstances," the trustee can only exercise powers that were vested in it by the indenture.<sup>451</sup> This attitude seems questionable in light of Landau's assertion that, in cases where the trustee concludes that the problematic aspect is seemingly temporary, or could be resolved with the obligor, it has the authority to act without reference to the bondholders.<sup>452</sup> This implies that the trustee has the right to act for the benefit of the bondholders as it sees fit, even without notifying the bondholders. In addition, the argument of the limited powers of the trustee is not consistent with the fact that Section 315(a) of the TIA specifically refers to a pre-default situation.<sup>453</sup> It determines that *prior to default* the trustee shall not be liable, "except for the performance of such duties as are specifically set out in such indenture."<sup>454</sup>

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<sup>444</sup> See Posner, *supra* note 2, at 199.

<sup>445</sup> See Johnson, *supra* note 41, at 95-6.

<sup>446</sup> See Draper, *supra* note 11, at 95-6.

<sup>447</sup> See 15 U.S.C. § 7700o(c).

<sup>448</sup> See *id.*

<sup>449</sup> See *id.*

<sup>450</sup> See LANDAU, *supra* note 63, at 179.

<sup>451</sup> *Id.*

<sup>452</sup> See *id.* at 181.

<sup>453</sup> See 15 U.S.C. § 7700o(a).

<sup>454</sup> *Id.* § 7700o(a)(1).

No similar provision governs the post-default situation. Thus, the conclusion should be that the trustee would be expected to act as a reasonably prudent person in protecting the bondholders' rights. Although no extraordinary actions will be anticipated, the trustee will definitely have to show flexibility and creativity in pursuing those rights. As it is impossible to prescribe a course of reaction or for that matter predict the possible triggering situations, it does not make much sense to say that the trustee is only able to use powers granted to it by the indenture. The least that could be expected of the trustee, when in doubt, is to either notify the bondholders of troubling facts or ask a court for instructions (both steps, of course, could be taken concurrently). In any event, the trustee must be aware that the courts are less likely to favor behavior of ignoring, overlooking, or elsewhere refraining from action under circumstances that require otherwise. The trustee should also recognize that the purpose of the TIA is to protect bondholders' interests and that must be the ultimate consideration in any decision taken by the trustee – whether to act or to refrain from action.

Besides the bankruptcy and reorganization route, which will be discussed below,<sup>455</sup> the trustee and the bondholders can deal with a default in diverse ways. The most obvious routes are negotiation, acceleration, and exercise of contractual remedies, and lawsuits in search for an injunction or specific performance order.<sup>456</sup> Other possibilities are a foreclosure action or a security fraud suit.<sup>457</sup> There are two main disadvantages related to the pursuit of those remedies. First, the trustee lacks the powers to act alone in these routes, as it needs the consent of the bondholders. For example, as mentioned above, the need for compromise in negotiation prevents the trustee from reaching significant achievements in this route.<sup>458</sup> Also, moving for the acceleration of the bonds usually requires the endorsement of a special percentage of the bondholders.<sup>459</sup> The second disadvantage in pursuing those remedies is that they will most likely trigger defaults of other debts of the obligor and eventually induce bankruptcy.

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<sup>455</sup> See discussion *infra* Part VII(c).

<sup>456</sup> See Steven R. Gross et al., *Restructuring Public Debt Outside Of Chapter 11*, 556 PLI/Comm. 23, 43 (1990).

<sup>457</sup> See *id.* at 49.

<sup>458</sup> See *id.* at 44 (suggesting that more investment houses specialize in troubled situations, allowing such bonds to be in the hands of a few sophisticated investors, allowing for a direct negotiation between bondholders and the obligor).

<sup>459</sup> See *id.* at 46.

### C. Bankruptcy and Reorganization

When default occurs the trustee has the authority, under Section 317(a)(1) of the TIA, to file a petition for reorganization of the issuer.<sup>460</sup> In this context, Robert Landau suggests that the trustee will regard such a petition as "an act of desperation" and "the last step to be taken."<sup>461</sup> Landau argues that such proceedings often result in losses to the bondholders. Other commentators have noted that in filing a bankruptcy petition, the trustee "deprives bondholders of an opportunity to participate with other creditors in an out-of-court debt restructuring."<sup>462</sup> Although the trustee is not expressly compelled to act in this situation, the ultimate objective of the trustee's actions must be the protection of bondholders. And if that objective dictates the filing of a petition, then this is what the trustee should do. The attempt to describe a trustee's petition as a last resort is inconsistent with its new standard of care. A prudent person would seek for alternative solutions, but only up to a certain point. If that point would be too far, the creditor knows the postponement only worsens his situation. Therefore, the trustee should weigh the probability that a quick solution will be found against the fear that a further postponement will decrease the chance of recovery. This should dictate whether the trustee should file for reorganization.

In most cases, at least where the bonds are unsecured,<sup>463</sup> liquidation in the sense of sale of the business or foreclosure will not result in substantial returns for bondholders.<sup>464</sup> Realizing that, bondholders usually support a process of reorganization. In voting on a reorganization plan, the indenture trustee is not entitled to make decisions as a representative of the bondholders, since such a plan involves compromises and adjustments in the indenture and in the bonds' financial terms.<sup>465</sup> The direct consent of the bondholders themselves is necessary.<sup>466</sup> Even if there is an attempt to accomplish reorganization or any solution that involves a compromise on the side of the bondholders out-of-court, the trustee does not have the authority to allow for such adjustments.<sup>467</sup>

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<sup>460</sup> See Trust Indenture Act of 1939 § 317(a)(1), 15 U.S.C. § 77qqq(a)(1) (1997).

<sup>461</sup> LANDAU, *supra* note 63, at 224.

<sup>462</sup> Gross, *supra* note 456, at 33.

<sup>463</sup> Although secured or senior bondholder might prefer liquidation, it is unlikely to happen due to the protection of the Bankruptcy Code that the issuer will immediately seek.

<sup>464</sup> See e.g., Wolcott B. Dunham & Peter L. Borowitz, *The Role of the Indenture Trustee in Reorganization Cases under the Bankruptcy Code*, 102 BANKR. L.J. 439, 444 (1985).

<sup>465</sup> See LANDAU, *supra* note 63, at 191.

<sup>466</sup> See *id.* (unless by judicial decree).

<sup>467</sup> See Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (1997).

Again, the bondholders themselves must convene and give their consent to the suggested plan.<sup>468</sup>

In some cases, the issuer's inability to pay debt results in the issuer seeking for protection under the Bankruptcy Code. Even if solvent, the issuer can file a bankruptcy petition under that Code.<sup>469</sup> Under section 303(b)(1) of the Bankruptcy Code, a trustee may commence an involuntary bankruptcy case against the issuer by joining at least two other creditors.<sup>470</sup> In all indentures, a bankruptcy petition filing, voluntary or involuntary, is defined as an event of default.<sup>471</sup> In such a case, the trustee's standard of conduct is raised to that of a prudent person.<sup>472</sup> Concurrently, the trustee is enjoined from pursuing the remedies mentioned in the indenture.<sup>473</sup> Due to the operation of the automatic stay, from that moment the trustee is subject to the orders of the court.

The right of the trustee to have its voice heard in the reorganization proceedings has been specifically recognized in Chapters 9 and 11 of the Bankruptcy Code. The trustee is not required to sit in the creditors' committee, although many do serve on such committees, seemingly under the belief that such a move is necessary under the prudent person standard.<sup>474</sup> The trustee may also intervene in the proceedings and is entitled to receive notices of any developments.<sup>475</sup> According to section 1109(b) of the Bankruptcy Code, the trustee is a "party in interest" and therefore the trustee may raise issues and be heard by the court.<sup>476</sup> Alongside its recognition of the trustee as the representative of the bondholders, the Bankruptcy Code emphasizes the bondholders' rights to represent themselves.<sup>477</sup> However, it should be noted that the collective representation by the trustee might have advantages even at this stage. Beside the impracticability of every bondholder showing up personally in the proceedings, the trustee voice — as a representative of a large mass of interests — might be more persuasive.

The trustee should attend most hearings to the extent that those are reasonably expected to affect the bondholders' position. This duty follows

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<sup>468</sup> See *id.*

<sup>469</sup> See Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 556 (1996) (challenging the constitutionality of giving solvent creditors relief under the Bankruptcy Code).

<sup>470</sup> See 11 U.S.C. § 303(b)(1) (1993).

<sup>471</sup> See COMMENTARIES ON INDENTURES, *supra* note 171, at 209.

<sup>472</sup> See 15 U.S.C. § 7700o(c).

<sup>473</sup> See 11 U.S.C. § 362 (automatic stay provision).

<sup>474</sup> See LANDAU, *supra* note 63, at 223.

<sup>475</sup> See 11 U.S.C. § 2202(f).

<sup>476</sup> See *id.* § 1109(b); see also *Mosser v. Darrow*, 341 U.S. 267, 270-71 (1951) (recognizing the indenture trustee's standing in the bankruptcy proceedings).

<sup>477</sup> See LANDAU, *supra* note 63, at 223.



from the prudent person standard.<sup>478</sup> In addition, the trustee should examine every motion filed in the proceeding in order to detect moves that might negatively affect the bondholders' position. Since under the Bankruptcy Code actions affecting the debtor's estate can be taken without an actual hearing if not requested timely by an interested party, the trustee must be alert.<sup>479</sup> Of course, once an action with negative affect is detected, the trustee must oppose the proposed action in court. Naturally, the trustee should also be highly attentive to any decisions made with regard to the security of the bonds, when there is such. On top of initiating appropriate actions in protecting the security, it should also be aware of actions that might erode the security.

Robert Landau suggests that the trustee will not be active in organizing a security holder committee, unless it is "necessary or desirable under the particular circumstances."<sup>480</sup> Yet admittedly, once the committee has been organized its interests will be usually identical to those of the trustee, as ordinarily a committee of unsecured creditors is appointed under Section 1102(a) of the Bankruptcy Code.<sup>481</sup> In any case, in pursuing adequate representation for the bondholders, the trustee has standing to seek changes in the membership or size of such a committee and request the appointment of an additional committee.<sup>482</sup>

"Despite its justifiable reluctance to take a position for or against a reorganization plan" out of fear of exposing itself to substantial liability, the trustee is still under the duty to act as a prudent person.<sup>483</sup> Thus, for example, the trustee should examine the obligor's disclosure statement, in order to find any discrepancies between the disclosure and information previously received by the trustee. In reality, most trustees refrain from making any recommendation as to the acceptance of the plan.<sup>484</sup> But, if the trustee asserts that there was some flaw in the reorganization plan or the approval procedure, it must file an objection. Although the bondholders might have already voted in favor of the plan, they obviously did so without the knowledge that raised the objection. Moreover, the trustee must also act for the interest of the minority of the bondholders, if there is such, which voted against the plan.<sup>485</sup>

<sup>478</sup> See Dunham & Borowitz, *supra* note 464, at 441; but see *In re Int'l Power Sec. Corp.*, 119 F. Supp. 31 (D.N.J. 1954), (disallowing part of a claim for reimbursement of the trustee's legal expenses, where it excessively monitored the court proceedings).

<sup>479</sup> See 11 U.S.C. § 102(1)(B).

<sup>480</sup> LANDAU, *supra* note 63, at 227.

<sup>481</sup> See 11 U.S.C. § 1102(a).

<sup>482</sup> See *id.*

<sup>483</sup> Dunham & Borowitz, *supra* note 464, at 454.

<sup>484</sup> See Gross, *supra* note 456, at 41.

<sup>485</sup> See *id.* at 42.

In this context it must be clear that the trustee represents *all* bondholders, including any minority.<sup>486</sup>

Another important responsibility is for the trustee to recognize when the reorganization proceedings have reached a dead-end. When it seems that the proceedings are not progressing, the trustee should be ready to move forward and request the bankruptcy court to convert the case into a liquidation case under Chapter 7.<sup>487</sup> This action should be taken only as an act of desperation, since bondholders have to be assured that the reorganization proceedings are not effective any more.<sup>488</sup> Since the reorganization proceedings assure that the creditors will not get fewer funds than were available to them upon liquidation, the liquidation must be a last resort choice.<sup>489</sup>

While the indenture itself, on its remedy provisions, is significant and even critical for the pursuance of the bondholders' rights, the trustee's importance as a representative of the bondholders decreases when the Bankruptcy Code is activated. The remedial provisions are normally not effective once a bankruptcy petition has been filed, and the automatic stay generated by the bankruptcy petition puts a stop to remedial proceedings already under way.<sup>490</sup> When bankruptcy proceedings begin, the bondholders themselves — through committees — make the critical decisions. Some might even argue that the indenture itself is set aside if a bankruptcy is filed. In many ways, once bankruptcy proceedings are generated, the bondholders become creditors as all creditors of the obligor. They are seldom able to take advantage of remedial provisions in the indenture, whether by themselves or through the trustee. At the same time, the bondholders' voice, or rather their vote, becomes their weapon in protecting their rights. Obviously, as argued above, the bondholders still need the trustee to act in their behalf and to utilize its powers, knowledge, and accessibility for their protection. As indicated, there are some points in which the trustee's intervention is not negligible. Yet, perhaps ironically, this is the situation that requires a relatively less active trustee.

### VIII. ACTIONS AGAINST THE TRUSTEE

Trustees have always been exposed to suits and liability. It seems to be an integral part of their role. The tendency to sue a trustee may derive from two factors. First, the trustee is one of the entities that was involved in the

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<sup>486</sup> See, e.g., *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 266-67 (1941).

<sup>487</sup> See 11 U.S.C. § 1112(b) (1993).

<sup>488</sup> See *Dunham & Borowitz*, *supra* note 464, at 450.

<sup>489</sup> See 11 U.S.C. § 1129(a)(7)(A)(ii).

<sup>490</sup> See *id.* § 362(a)(1).

issuance, and it also has a continuing role during the life of the bonds. Therefore, it is seen as being responsible for the bonds, especially in light of the complex relations it often has with the issuer and the underwriter. Second, the trustee is seen as the bondholders' guardian, with its title encouraging people to put their trust in it. So when bondholders face losses and feel betrayed, they see the trustee as someone who failed to protect them. Alongside, issuers view the trustee as a burden, continuously putting demands on the issuer, and thus interfering with the issuer's business operations. Thus, the trustee is considered to be both part of the group that failed investors and a factor that contributed to the issuer's failure.

An article by Richard Schreiber and Thomas Wood opened its discussion on the topic of trustee liability with an entertaining anecdote, that although told from a trustee's point of view, it is worth quoting: "[w]hen asked why he robbed banks, notorious 1930's felon Willie Sutton responded: 'because that's where they keep the money' ... it seems fair to name in his honor what might be called Sutton's Law of Litigation: 'when in doubt, sue the bank.'"<sup>491</sup>

In the pre-TIA period, the indenture trustee seemed to be able to avoid many suits, or at least win a ruling in its favor, with the help of exculpatory clauses included in indentures.<sup>492</sup> In the very early case of *Sturges v. Knupp*, a court held that an indenture trustee was bound by the same standards of fiduciary obligations that a private trustee owes his beneficiaries.<sup>493</sup> Arguably, this decision motivated trustees to protect themselves through exculpatory clauses. At first, typical exculpatory clauses relieved trustees from all liability except for gross negligence and willful misconduct.<sup>494</sup> However, as the duties of various trustees broadened, specific exculpatory clauses appeared and multiplied.<sup>495</sup> At some point, the clauses seemed to protect trustees from any error or misfortune.<sup>496</sup> The only exceptions might have been fraud and misappropriation of funds.<sup>497</sup> Whereas protection against gross negligence, willful default and acts done in bad faith was considered against public policy and therefore unenforceable,<sup>498</sup> courts were careful not to deny that "some weight may be attributed to the exculpatory clause."<sup>499</sup> Although it is

<sup>491</sup> Richard B. Schreiber & Thomas G. Wood, *Caveat Indenture Trustee: Avoiding the Expanding Scope of Sutton's Law*, 121 TRS. & ESTS. 48 (1982).

<sup>492</sup> See Obrzut, *supra* note 41, at 134.

<sup>493</sup> *Sturges v. Knupp*, 31 Vt. 1 (Vt. 1858).

<sup>494</sup> See Banks, *supra* note 13, at 533.

<sup>495</sup> See *id.*

<sup>496</sup> See *id.*

<sup>497</sup> See *id.*

<sup>498</sup> See *Browning v. Fidelity Trust Co.*, 250 F. 321, 324 (3d Cir. 1918).

<sup>499</sup> Philip M. Payne, *Exculpatory Clauses in Corporate Mortgages and Other Instruments*, 19 CORNELL L.Q. 171, 196 (1934).

impossible to assess how many suits were avoided due to the exculpatory clauses and although the courts tended to regard those clauses with evident distaste, they still seemed to offer some immunity to trustees.<sup>500</sup>

After the TIA's enactment, the scope of the exculpatory clause was limited.<sup>501</sup> Yet, the trustee's role, as defined by the legislation, was also limited. The narrow articulation of the TIA and the indentures made courts more reluctant to apply fiduciary elements to the relationships. Instead, courts favored the contractual—and narrower—interpretation.<sup>502</sup>

Indeed, the first possible claim against a trustee that comes to mind is the breach of contract claim. Bondholders can argue that the trustee breached its duties as specified in the indenture. Of course, as in any contractually based suit, the bondholders must prove all elements of the action. There should be no difficulty in showing the validity of the contract and the bondholders' performance of their duties under the contract. The more difficult obstacle is proving that the trustee breached the indenture by failing to perform its duties and that the bondholders were damaged *as a result of that breach*. The last two elements would be at the center of the litigation.

A related claim relies on the implied covenant of good faith and fair dealing derived from the indenture.<sup>503</sup> The claim is based on the principle that "the law implies in every contract a covenant to act fairly and in good faith in the course of performing the contract."<sup>504</sup> As mentioned above, bondholders increasingly rely on this doctrine.<sup>505</sup> For example, the court in the case of *Katz v. Oak Industries* recognized the right of action under the implied covenant of good faith and fair dealing.<sup>506</sup>

Another cause of action against the trustee is the claim of breach of fiduciary duty. As mentioned before, some courts were reluctant to apply such duty on the trustee, especially in the pre-default situation.<sup>507</sup> Yet in other

<sup>500</sup> See Banks, *supra* note 13, at 533.

<sup>501</sup> See Trust Indenture Act of 1939 § 315(d), 15 U.S.C. § 7700o(d) (1997).

<sup>502</sup> See discussion *supra* Section V(E); see also Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974; Simon v. Cogan, 542 A.2d 785 (Del. Ch. 1987)).

<sup>503</sup> See discussion *supra* Part V(E).

<sup>504</sup> James E. Spiotto, *Overview of Causes of Action Available To The Indenture Trustee*, 409 PLI/REAL 681, 684 (1995).

<sup>505</sup> See, e.g., Metropolitan Life Ins. Co. v. R.J.R. Nabisco, Inc., F. Supp. 1504 (S.D.N.Y. 1989) (holding that when consistent with the expressed terms of indentures, a trustee's responsibility can be established through the mechanism of the implied covenant of good faith and fair dealing).

<sup>506</sup> Katz v. Oak Industries, 508 A.2d 873 (Del. Ch. 1986).

<sup>507</sup> See, e.g., Groseclose v. Merchant Nat'l. Bank & Trust Co., 335 N.Y.S.2d 652 (Sup. Ct. 1972); Eldred v. Merchants Nat'l Bank, 468 N.W.2d 221 (Iowa 1991).

cases, such a duty was recognized.<sup>508</sup> In *Elliott Associates*, the court refused to apply a fiduciary duty and distinguished the ruling in *Dabney* to cases in which the trustee has a clear conflict of interest.<sup>509</sup> Therefore, at least in those situations, it is still possible to win a case against the trustee under this cause of action.

In addition, some courts have recognized a private right of action under the TIA.<sup>510</sup> Prior to the Act's passage, indentures, as private contracts, had been governed by the common law of contracts and fiduciary obligations, articulated primarily in the state courts.<sup>511</sup> Since the TIA did not expressly authorize federal jurisdiction, it was not clear whether such action could be brought. In *Caplin v. Marine Midland Grace Trust*, the Second Circuit recognized the possibility of such a right of action.<sup>512</sup> In *Morris v. Cantor*, a federal district court held that, upon careful reading of the TIA, the Act created substantive liabilities in those areas it specifically addresses.<sup>513</sup> This means a bondholder can sue the trustee in federal court, claiming for a breach of the TIA. For example, bondholders can claim that the trustee did not comply with the eligibility requirements of the Act.

Since a trustee's conduct can be examined under a negligence standard, it is possible to bring a suit against it under a negligence cause of action. Bondholders would simply argue that the trustee was negligent in a specific act or negligent in the failure to act, like in any other negligence suit.<sup>514</sup>

Securities fraud is another possible cause of action that bondholders can use against a trustee. Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5, promulgated by the SEC under the Securities Exchange Act declare that any person is prohibited from *directly or indirectly* engaging in any fraudulent practice upon any person in connection with the purchase or sale of securities.<sup>515</sup> A trustee could fall in the category of aiding and abetting.

<sup>508</sup> See, e.g., *Dabney v. Chase Nat'l Bank*, 196 F. 2d 668 (2d Cir. 1952); see also *Broad v. Rockwell*, 614 F.2d 418 (5th Cir. 1980).

<sup>509</sup> *Elliott Assocs. v. J. Henry Schroder Bank & Trust Co.*, 655 F. Supp 1281 (S.D.N.Y. 1987).

<sup>510</sup> See, e.g., *Zeffiro v. First Pennsylvania Banking & Trust Co.*, 623 F.2d 290 (3d Cir. 1980) (TIA provided injured bondholders with federal cause of action for breach of terms mandated by the Act).

<sup>511</sup> See *Obrzut*, *supra* note 41, at 144-45.

<sup>512</sup> *Caplin v. Marine Midland Grace Trust*, 439 F.2d 118 (2d Cir. 1971). While the Second Circuit held that the Bankruptcy trustee did not have standing to assert claims against the indenture trustee on behalf of the bondholders, the court assumed that violation of the TIA would give rise to a cause of action against the indenture trustee by the bondholders. The court stated in footnote 17 of the holding that if there is indeed such cause, it would give federal courts jurisdiction. *Id.*

<sup>513</sup> *Morris v. Canton*, 390 F. Supp. 817 (S.D.N.Y. 1975).

<sup>514</sup> See James E. Spiotto, *Theories of Liability Which Have Been Raised Against The Indenture Trustee*, 409 PLI/REAL 671, 674-75 (1995) (noting a case in which bondholders won a suit against a trustee based on a negligence theory).

<sup>515</sup> See Securities Exchange Act of 1934 § 15(b), 15 U.S.C. § 78j(j) (1998).

However, since the term of aiding does not specifically exist in the 1934 Securities Exchange Act, the court in *Anixter v. Home-Stake Production* did not find a trustee liable under this security fraud claim.<sup>516</sup> Moreover, in *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court emphasized the difference between the primary violation of the security fraud provisions and the aiding and abetting violations.<sup>517</sup> The Court explained that the primary violation occurred when the defendant made a false representation, either by statement or omission, which the plaintiff relied upon.<sup>518</sup> The Court continued that reliance only on representations made by others cannot itself form the basis of liability.<sup>519</sup> In the final analysis, the Court held the defendant liable as an aider and abettor under § 10(b).<sup>520</sup> Thus, the Court required substantial assistance by the alleged aider in achieving the primary violation. Therefore, this cause of action against a trustee is likely to be dismissed by courts, as long as the trustee is not charged with fraudulent conduct.

One commentator has vigorously attacked the decision of *Central Bank*, and he revealed that the SEC has asked Congress to legislatively overturn *Central Bank*.<sup>521</sup> Legislation has been introduced in the Senate according to which Section 10(b) will include aiding-and-abetting liability.<sup>522</sup> "Not surprisingly, legislative efforts to restore [that] liability have met intense and well-financed opposition from securities professionals and other potential targets of 10b-5 liability."<sup>523</sup> Thus, in the absence of amending legislation, bondholders might be successful in asserting a primary wrongdoing of the trustee, rather than filing an aider-and-abettor claim.<sup>524</sup>

## IX. THE "SUPERTRUSTEE" SUGGESTION : A NOTE

In a recently published article, Yakov Amihud, Kenneth Garbade and Marcel Kahan propose a new governance structure for publicly issued

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<sup>516</sup> *Anixter v. Home-Stake Production*, 77 F.3d 1215 (10th Cir. 1996).

<sup>517</sup> *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

<sup>518</sup> *See id.* at 177.

<sup>519</sup> *See id.*

<sup>520</sup> *See id.*

<sup>521</sup> *See* Robert P. Varian, *The Demise of Aider-And-Abettor Liability Under Rule 10B-5: The Implications For Banks and Trust Companies*, 112 BANKING L.J. 246, 269 (1995)

<sup>522</sup> *See id.* at 269.

<sup>523</sup> *Id.* at 269-70.

<sup>524</sup> *See, e.g., Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc) (holding the trustee to be primary liable under section 10b-5 on grounds that it was a knowing participation in a fraudulent scheme to market bonds).

corporate bonds.<sup>525</sup> This proposal is designed to be voluntarily adopted by corporations, and suggests only minor modifications in the TIA.<sup>526</sup> At the center of the suggestion is a newly introduced "supertrustee," which would serve as an agent of public bondholders.<sup>527</sup> The supertrustee would have "the duty and power to actively monitor, renegotiate, and enforce bond covenants."<sup>528</sup> The supertrustee may seem to resemble the "activated" trustee that was suggested earlier in this article.<sup>529</sup> Indeed, the description of the trustee's role appears to be fairly similar. Yet the proposals significantly differ. The two concepts do not take the same view, do not use the same arguments, nor do they come to the same conclusions.

The supertrustee proposal's point of view is the efficiency of corporate governance.<sup>530</sup> Amihud, Garbade and Kahan attempt to offer a solution, which overcomes the collective action problem<sup>531</sup> and the bonding problem.<sup>532</sup> Thus, agency costs and efficiency considerations govern their analysis.<sup>533</sup> Surely, such considerations should never be ignored, but according to this present study's view efficiency should be achieved *along with* an adequate protection and representation of bondholders' interests, and not at the expense of the latter. Most importantly, the supertrustee proposal fails to address the problem of conflict of interest that might lead to costly consequences to bondholders and to society.

According to the proposal of Amihud, Garbade and Kahan, the issuer itself appoints the supertrustee.<sup>534</sup> They argue that the issuer's self interest will be to appoint a supertrustee that effectively represents the bondholders, since as a consequence the issuer will benefit from a lower interest rate on the debt.<sup>535</sup> As argued above,<sup>536</sup> the mere appointment of the trustee by the issuer is problematic since the trustee should not be oriented to the issuer in order to avoid conflict of interest issues. Moreover, the conflict of interests issue is accentuated, in light of the further suggestion to appoint the same supertrustee

<sup>525</sup> See Amihud, *supra* note 74, at 447.

<sup>526</sup> See *id.* at 451-52.

<sup>527</sup> See *id.* at 451

<sup>528</sup> *Id.*

<sup>529</sup> See discussion *supra* Part V(G).

<sup>530</sup> See Amihud, *supra* note 74, at 454.

<sup>531</sup> See discussion *supra* Part V(G).

<sup>532</sup> The bonding problem, created by the fluidity of the bonds, is the issuer's inability to have control over the identity of the debt owners, and therefore loss of efficiency that originates from the reputation of the lender. See Amihud, *supra* note 74, at 460.

<sup>533</sup> See *id.* at 454.

<sup>534</sup> See *id.* at 471.

<sup>535</sup> See *id.* at 454.

<sup>536</sup> See discussion *supra* Part IV(D).

for several bonds issues of the same company.<sup>537</sup> As this will surely reduce the cost of the supertrusteeship and "enhance the economic feasibility of the proposal,"<sup>538</sup> it will of course create a clear conflict of interest that lessens the ability of the supertrustee to act as faithful representative of the bondholders.<sup>539</sup> Such a conflict was recognized by section 310(b)(1) of the TIA.<sup>540</sup>

In addition, according to the Amihud, Garbade and Kahan proposal, the supertrustee has the ability to negotiate and compromise the terms of the bonds as an agent of the bondholders.<sup>541</sup> In fact, the bondholders are not entitled to direct the supertrustee to take any particular enforcement action,<sup>542</sup> nor will the supertrustee seek bondholders' approval for waiving a breach in the indenture in exchange for higher interest payment or additional collateral.<sup>543</sup> It is true that the trustee might act opportunistically in the sense that its broader responsibility will encourage it to make more positive enforcement decisions. The prudent man standard of care, however, should guard the issuer and the bondholders from that risk. Prohibiting bondholders from making critical decisions about their investment seems an extreme step, which also reduces the probability that bondholders will be willing to adopt the supertrustee suggestion. Also notice that any breach of the indenture's covenants might be an indication of the company's deteriorating financial stability. Therefore, it is not always in the bondholders' interests to accept a higher interest payment in exchange for a breach. In such situations the risk of the investment should be assessed and the bondholders should decide whether or not to accept that additional risk for the terms offered. Moreover, the ability of the trustee to negotiate and compromise as an agent of the bondholders must be restricted by conflict of interest prohibition and therefore, the subject is best addressed through regulation and not through a voluntary mechanism, operated by the issuer.

The supertrustee suggestion also included a recommendation to limit the liability of the supertrustee in order to allow the implementation of the plan.<sup>544</sup> While it is agreeable that any broadening of the trustee's responsibilities increases the exposure of the trustee, the restricted liability suggested by Amihud, Garbade and Kahan seems excessive. For example, the

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<sup>537</sup> See *id.* at 490.

<sup>538</sup> *Id.*

<sup>539</sup> See discussion *supra* Part IV(D).

<sup>540</sup> See The Trust Indenture Act of 1939 § 310(b)(1), 15 U.S.C. § 77jjj(b)(1) (1997).

<sup>541</sup> See Amihud, *supra* note 74, at 470.

<sup>542</sup> See *id.* at 476.

<sup>543</sup> See *id.* n.105.

<sup>544</sup> See *id.* The supertrustee suggestion is bound to expose the supertrustee to non-meritorious lawsuits and second-guessing by courts, thereby raising the implicit costs of the supertrusteeship.



recommendation is that only bondholders who own 10 percent of the company's bonds can sue the supertrustee (unless the supertrustee acted in bad faith).<sup>545</sup> Since public debt issues are mostly greater than \$100 million, with a median of \$150 million and a mean of \$181 million,<sup>546</sup> and since sometimes a bondholder owns only a small fraction of the company's bonds, it will be very difficult for bondholders to sue the trustee under such restriction.

Another limitation on the supertrustee's liability is the standard of care recommended. Amihud, Garbade and Kahan suggest that "the supertrustee's decisions with regard to enforcement and renegotiation should be evaluated under a liability standard analogous to the 'business judgment rule' applicable to decisions taken by a board of directors."<sup>547</sup> Under this standard, bondholders will not be able to question the supertrustee's judgment that are "merely wrong or *substantively unreasonable*."<sup>548</sup> Compared with the TIA's standard of the prudent person,<sup>549</sup> the business judgment standard is described by Amihud, Garbade and Kahan as putting fewer limits on the trustee.<sup>550</sup> First, it should be noted that courts would not necessarily interpret the prudent person standard as a prudent public bondholder. It is arguable that courts would examine trustees against a prudent private creditor standard. Moreover, in contrast to the supertrustee suggestion, the prudent person standard allows taking into consideration the effect of the trustee's conduct on "future business."<sup>551</sup> According to the suggestion of the activated trustee, the trustee should be able to weigh the benefits and risks of its conduct — including the ability of the issuer to recover from a temporary financial or business difficulty. If such recovery is probable, then it could be in the interest of the bondholders to refrain from any action. If so, then that is how the trustee should react since this is how a prudent person would react while considering the future of the obligor's business. Therefore, the two standards of care discussed are not significantly different. Also, in any lawsuit on this matter, courts will engage in "after-the-fact second-guessing" of the trustee's decisions,<sup>552</sup> whatever the standard of care. Although costly, this is what courts are doing in many areas of the law.

The actual role of the supertrustee, as described in the supertrustee suggestion, is very similar to the role of the activated trustee suggested in this

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<sup>545</sup> See *id.*

<sup>546</sup> See *id.* at 477-78.

<sup>547</sup> *Id.* at 478.

<sup>548</sup> *Id.*

<sup>549</sup> See Trust Indenture Act of 1938 § 315(c), 15 U.S.C. § 7700o(c) (1997).

<sup>550</sup> See Amihud, *supra* note 74, at 478-79.

<sup>551</sup> *Id.* at 479.

<sup>552</sup> *Id.*

article. The supertrustee has "the duty to monitor, actively and independently," the compliance of the issuer with the indenture's provisions.<sup>553</sup> Consequently, it must be given access to information as a private lender and not permitted to rely on the issuer's statements.<sup>554</sup> These requirements must also apply to the activated trustee.<sup>555</sup> In addition, Amihud, Garbade and Kahan propose a flexible compensation scheme designed to motivate the supertrustee to monitor the issuer is appealing. According to this scheme, trustee compensation will be positively tied to changes in the bond value, short of the influence of fluctuations in interest rates on U.S. treasury bonds.<sup>556</sup> This compensation method is also appealing in the context of the activated trustee suggestion, since it motivates the trustee to be more active and more concerned with the interests of the bondholders.

It is the framework of the suggestion that is questionable. Amihud, Garbade and Kahan even admit that "network externalities" lead to a situation where "even if some market participants find the proposal attractive, none may be willing to be the first to adopt it."<sup>557</sup> Potential supertrustees will be afraid of the inherent liability to which it will be exposed, the potential bondholders will fear the marketability of such bonds in the secondary market due to the relatively lower yield, and issuers will be reluctant to put further restrictions on the management's discretion. Amihud, Garbade and Kahan suggest that underwriters will assume this role of educating the public,<sup>558</sup> but it still remains problematic, as it is not clear what would be the underwriters' incentive to do so. Even assuming that the supertrustee suggestion can be implemented, the question is why should we trust issuers and the other private parties involved, to make critical decisions regarding the protection of bondholders. In contrast to the view of Amihud, Garbade and Kahan, the activated trustee proposal is regulation oriented. It assumes that the bondholders' interests need to be protected actively and impartially by one entity, thus reducing the collective action problem. Keeping the bondholders away from making decisions regarding their investment and preventing them from suing an unreasonable trustee will not contribute to that goal, but might be an obstacle to the popularity of the public bond market. The "activated" trustee—with broader statutory responsibilities—will have the means to act in a non-opportunistic manner, thus contributing to the corporate and the

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<sup>553</sup> *Id.* at 472.

<sup>554</sup> *See id.*

<sup>555</sup> *See* discussion *supra* Part V(G).

<sup>556</sup> According to the suggestion, this is supposed to be achieved by a set of derivative securities. *See* Amihud, *supra* note 74, at 480.

<sup>557</sup> *Id.* at 489.

<sup>558</sup> *See id.*

society's efficiency. It is hard to believe that such a change can be accomplished voluntarily, and in any case we should not rely on market forces to achieve that. As we know, those forces do not always lead to a competitive market outcome.

## X. CONCLUSION

We should not wait for the next upsurge in issuer failures and bondholder losses in order to amend the TIA. The current structure of the TIA, and the trustees it creates, affects millions of investors. Not only is their money at stake, but the stability and growth of the whole market economy.

In June 1996, the House of Representatives passed a bill that called for the SEC to submit a study on the benefits, possible modification, or total elimination of the TIA.<sup>559</sup> Yet the companion Senate bill did not include that study request, and no conference report has been published on the issue. The motivation for that unsuccessful initiative was the call to repeal the TIA due to the trustees' passivity and redundant role.<sup>560</sup> Although the attempt is still unsuccessful, repealing the TIA altogether is like "throwing out the baby with the bathwater." Although the TIA has several flaws and the trustee's role needs to be redefined to better achieve the goals of the TIA, the TIA should be amended to suit modern market conditions rather than repealed.

In fact, the transactions in and between corporations during the last fifty years have elevated the risk and vulnerability of bondholders. Thus, on the verge of the 21st Century, there is still a fundamental need for protecting bondholders and solving the collective action problem. The trustee should be at the center of the mechanism designed to answer that need.

As argued throughout this article, the current construction of the TIA does not serve the purpose for which it was enacted or the economic interest of bondholders. The historical and legislative development in this field has led to the conclusion that the lack of protection for bondholders could bring disastrous consequences. It was the TIA's objective to create an active guardian for bondholders. Yet, interest group pressures contributed to some critical discrepancies in the Act that could not be corrected by the courts. The actual restraints on obligors and trustees with regard to the bondholders are therefore much less effective than the presumptuous legislative intention of the TIA.

It has also been illustrated that the flaws in the TIA and in the trustee's characterization by the TIA could and should be cured. The assertion of this

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<sup>559</sup> See James Gadsden, *Trust Indenture Act Under Attack*, 113 *BANKING L.J.* 967, 967 (1996).

<sup>560</sup> See *id.* at 968.

article is that the pre-default and post-default dichotomy with regard to the trustee's duties and responsibilities should be revoked. The pre-default situation bears risks for bondholders as much as the post-default situation does. Bondholders are not only exposed to dangers originating from management's opportunism, they also risk losing their investment due to conflicts of interest with trustees. In addition, the bondholders' position is highly jeopardized during the negotiation stage, preceding the closure of the indenture. As argued, it is more likely that bondholders will successfully protect their investments before default occurs. Therefore, the trustee should be able and willing to act effectively in pursuing the bondholders' interests at that time.

Another assertion of this article is that the trustee must be truly freed from any conflicting interests in order to be an effective protector of the bondholders. Impartial judgment and unbiased decision-making at all stages, including the pre-default situation, are critical for encouraging the trustee to be an active, prudent and effective representative of the bondholders.

Accordingly, the argument is that the trustee should be activated in the pre-default situation and judged according to the same standard of care that governs the trustee in the post-default situation — the prudent person in the conduct of his own affairs. This proposal equates the trustee to a private debt lender, which will dramatically contribute to the protection of bondholders during the whole course of the bonds' life — from the negotiation stage to foreclosure. The added protection, if adequately backed by legislation, will also contribute to the efficient corporate governance and better allocation of efficiencies in society.

